

**Before the  
Federal Communications Commission  
Washington, D.C. 20554**

In the Matter of	)	
	)	
AT&T Corp.	)	
	)	
Petition for Rulemaking To Reform	)	RM No. 10593
Regulation of Incumbent Local Exchange	)	
Carrier Rates For Special Access Services	)	

**COMMENTS OF BELL SOUTH**

**BELL SOUTH CORPORATION**

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BellSouth Corporation, on behalf of itself and its wholly owned subsidiaries, ("BellSouth"), hereby submits the following Comments on the Petition For Rulemaking filed by AT&T Corp.<sup>1</sup>

**I. INTRODUCTION AND SUMMARY**

1. Although couched as a petition to reform special access rates, AT&T's petition for rulemaking amounts to little more than a request to rescind the regulatory reforms that the Commission has implemented over the last twelve years. Under AT&T's theory, the Commission is supposed to undo the progress it has made to reform regulation and take a giant step backward in time and reinitiate what would amount to the same failed cost-of-service-based form of regulation that it abandoned over a decade ago.

2. To support its request for an antique form of regulation, AT&T dredges out every argument it has used in the past to block regulatory reform. In AT&T's estimation, arguments

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<sup>1</sup> AT&T Corp. Petition for Rulemaking To Reform Regulation of Incumbent Local Exchange Carrier Rates For Special Access Services, RM No. 10593 (filed Oct. 15, 2002) ("AT&T Petition").

that were not persuasive in their original outing somehow gain influence by being repackaged. While "new and improved" packaging may work for laundry detergent, it does little to give validity to AT&T's secondhand arguments.

3. As shown below, AT&T is wrong in its claim that special access earnings are excessive and that they demonstrate LEC market power. Regulatory earnings have no significance in assessing market power, nor do the data relied on by AT&T in any way suggest that pricing flexibility is operating in an unintended way. The data series upon which AT&T bases its analysis predates pricing flexibility. Thus, in essence, AT&T is challenging price cap regulation; but, the challenge must fail. Price cap regulation never was intended to constrain earnings. Instead, price cap regulation constrains prices and invites carriers to become more efficient and to increase earnings subject to the price cap limits. All that earnings can show is how successful a price cap carrier has been in light of the price limitations. Earnings under price caps have nothing to do with whether rates are just and reasonable.

4. BellSouth also demonstrates that the margin between prices and incremental costs has nothing to do with market power. The telecommunications industry is characterized by substantial fixed costs that require that rates be set in excess of incremental costs. Permitting market forces to determine the manner in which shared and common costs are recovered results in a set of more efficient prices than would occur by the Commission arbitrarily dictating the allocation of such costs through a cost methodology, irrespective of whether the methodology is called TELRIC, FDC or separations.

5. An equally doomed argument is AT&T's claim that the special access market is not competitive. As shown below, AT&T's claim simply cannot measure up to the facts.

Competition has been firmly established in the market for some time and it continues to thrive.

6. The competitive conditions of the marketplace support the pricing flexibility that the Commission has afforded special access. The optional pricing plans that pricing flexibility has enabled are procompetitive and should be encouraged by the Commission. AT&T's desire to undo pricing flexibility has nothing to do with promoting competition. To the contrary, AT&T's request for the Commission to take a giant regulatory step backward is intended to achieve one purpose and one purpose only – to prevent LECs from competing in the marketplace. The Commission should reject the anticompetitive intrigues of AT&T.

## **II. NO BASIS EXISTS FOR ALTERING THE REGULATORY PARADIGM FOR SPECIAL ACCESS**

7. AT&T's claim that pricing flexibility has failed amounts to nothing more than the platform upon which it attempts to reanimate the fruitless arguments that it has made over the last 12 years in attempts to block any type of regulatory reform. Contrary to AT&T's apparent belief, its arguments are not like fine wines, they do not improve with age.

8. As shown below, the data relied on by AT&T are not evidence of failed regulatory policies. Indeed, virtually none of the data can be related to the performance of the Commission's pricing flexibility rules. Moreover, the pricing, earnings and revenue data relied upon by AT&T do not support its claim that LECs retain market power in special access markets or that competition is inadequate to discipline prices.

**A. AT&T's Reliance on Rate of Return Data Is Meaningless**

9. The cornerstone of AT&T's petition is its claim that the rates of return for special access are excessive and that the historical returns are conclusive proof that the LECs possess market power.<sup>2</sup> AT&T's argument is flawed in a number of respects.

10. A regulatory rate of return calculation is not the measure of the reasonableness of a given set of rates. No matter how much AT&T wants to turn back the hands of time, the Commission has long recognized that rate of return is not an effective regulatory mechanism for assuring just and reasonable rates. Having abandoned rate of return as a regulatory paradigm over a decade ago, AT&T's contention that rate of return signals some form of market failure is nonsensical.

11. Indeed, economists have discounted the significance of regulated rates of return in assessing market power. As Kahn and Taylor point out, "[h]igh or increasing rates of return calculated using regulatory cost assignments for interstate special access services do not in themselves indicate excessive economic earnings reflecting the exercise of market power."<sup>3</sup> Totally missed by AT&T is the fact that the LECs are integrated multi-regional firms that rely on integrated regional management structures employing regional physical and human resources to provide multiple interstate and intrastate services. In these circumstances, "regulatory rates of return for geographic subsets of single services in multi-product, multi-geography firms bear no relationship with economic profits and thus can serve no useful purpose in determining whether

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<sup>2</sup> AT&T Petition at 8.

<sup>3</sup> Declaration of Alfred E. Kahn and William E. Taylor On Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon Communications, Inc., attached as Exhibit 1, at 7 ("Kahn/Taylor Decl.").

pricing flexibility has or has not been excessively permissive.”<sup>4</sup> In other words, the cost allocations necessary to derive a special access rate of return render the calculation itself meaningless.

12. The caution regarding “rates of return” sounded by economists holds particular relevance here. Deriving a special access return is dependent on numerous arbitrary cost allocations that are no longer pertinent or important to the manner in which both state and federal regulatory agencies execute their obligations to regulate LECs. Thus, for example, BellSouth has not been regulated on a rate of return basis in either the state or federal jurisdictions for many years. Accordingly, the formal allocation of costs between jurisdictions has become irrelevant.

13. Because the connection between jurisdictional allocations and ratemaking and pricing has been severed, the overarching imperative has been to simplify and to reduce the regulatory burden associated with the process. Thus, since July 2001, the jurisdictional separations process has operated under a separations freeze.<sup>5</sup> While the process provides broad jurisdictional cost boundaries for oversight purposes, there has been no need to keep jurisdictional separations on track with the rapid technological and market changes that have been occurring.

14. Jurisdictional separations was developed in an era of local monopolies, circuit switched networks and a clear delineation between jurisdictions and services. It does not reflect the rapid changes in the telecommunications infrastructure, such as the growth in Internet usage and the increased usage of packet switching and high-bandwidth technologies or the attendant blurring distinctions among and between services and jurisdictions. The widening chasm

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<sup>4</sup> *Id.*

<sup>5</sup> *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Report and Order*, 16 FCC Rcd 11382 (2001).

between jurisdictional separations and market realities diminishes the reliability of such results for the purpose of measuring profits or earnings.

15. The special access rates of return cited by AT&T demonstrate the unreliability of these data. One of the largest growth components for BellSouth has been DSL. Jurisdictionally, 100 percent of DSL revenues are interstate and classified as special access. The jurisdictional separations process, however, only assigns a fraction of the costs associated with DSL to the private line category and, accordingly, only a fraction of the costs are associated with special access.<sup>6</sup> As a result, the revenues associated with the growth in these special access services are reflected in the rate of return, but not the costs. The discontinuity between service costs and revenues confirms that broad allocation mechanisms such as jurisdictional separations have no relevance to measuring the reasonableness of service rates or service-specific earnings.

16. Apart from the infirmities of the rates of return relied on by AT&T, the data are for time periods that precede the implementation of pricing flexibility.<sup>7</sup> Essentially, the data present a challenge to the Commission's price cap rules. The challenge fails because the essential feature of price caps is the abandonment of earnings regulation in favor of regulation of overall prices. In 1991, the Commission took a bold step by abandoning its traditional approach to

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<sup>6</sup> Based on the current procedures, BellSouth currently assigns DSLAM circuit investment to separations Category 4.11, which is directly assigned to Special Access. However, DSL switching, trunking, cable and wire and support investments are not directly assigned to Special Access but instead are separated between interstate (all rate elements) and intrastate. Also, all of BellSouth's DSL expenses are separated between interstate and intrastate based on existing separations procedures, causing less than 20% of actual DSL expenses to be allocated to Special Access, while 100% of the DSL revenues are assigned to Special Access. Therefore, Special Access is not assigned a substantial portion of the expenses (more than 80%) that are incurred in providing DSL service, but includes all of the revenue.

<sup>7</sup> For example, one of AT&T's complaints with pricing flexibility is that BellSouth raised certain special access rates. The month-to-month special access rates that BellSouth raised did not take effect until November 1, 2001.



regulating local exchange carriers and adopted price cap regulation. Price cap regulation replaced the conventional rate-of-return or cost-plus system of regulation with an incentive-based price cap system. With price cap regulation, the Commission sought to replicate the beneficial incentives of competition in the provision of access services, striking a reasonable balance between the interests of ratepayers and stockholders. As the Commission explained, “[p]rice cap regulation is intended to encourage growth in productivity by permitting incumbent LECs that increase their productivity to earn higher profits, while at the same time ensuring that interstate access customers share in the benefits of productivity growth in the form of lower rates.”<sup>8</sup> Thus, the Commission fundamentally redefined the regulatory paradigm for local exchange carriers and implemented a system that ensured that both carriers and customers would be better off.

17. Price cap regulation, by incorporating profit-making incentives that are common to all non-regulated businesses, produces a set of outcomes that advance the public interest. Thus, this system of regulation results in just, reasonable and nondiscriminatory rates for consumers as well as an environment that fosters investment in the telecommunications infrastructure that is essential to the provision of innovative, high-quality telecommunications services. Indeed, the Commission’s reviews of price cap regulation have recognized that the promise of incentive-based regulation has been realized.

18. Incentive-based regulation, like price caps and pricing flexibility, has played an important role in achieving the public policy goals of the Commission. The beneficial results

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<sup>8</sup> *In the Matter of Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform*, CC Docket Nos. 94-1 and 96-262, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642, 16645-46, ¶ 2 (1997).

that have been realized by both consumers and carriers could not have been obtained under a traditional cost-plus system of regulation. The Commission recognized early on that moving away from rate-of-return regulation to incentive-based regulation “replicate[s] more accurately than rate of return the dynamic, consumer-oriented process that characterizes a competitive market.”<sup>9</sup> By breaking the direct link between prices and earnings, the price cap system of regulation blunted the perverse incentives associated with cost-plus regulation.<sup>10</sup>

19. Equally important is that the Commission has found price caps a superincumbent form of regulation not because competition was in place but rather because price caps better emulated the outcomes that a fully competitive market would produce. Thus, the justification of price cap regulation lies not in the presence of competition, but instead in its absence. Indeed, the presence of effective competition justifies the relaxation and elimination of price cap regulation.

20. Price cap regulation represents a compact between the regulated firm and the regulator in which prices are regulated but the firm is free to earn whatever it can, subject to the constraint on its prices. In this way, the regulated firm faces the same incentives that an unregulated firm has in competitive markets, where it, too, is a price-taker but is free to earn whatever it can subject to the constraint that its prices are limited by the market. Earnings in the price-cap case cannot be excessive, because the regulatory bargain constrained prices, not

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<sup>9</sup> *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, *Report and Order and Second Further Notice of Proposed Rulemaking*, 4 FCC Rcd 2873, 2893, ¶ 36 (1989).

<sup>10</sup> Under traditional rate-of-return and its derivative cost-of-service regulation, cost inefficiencies and cost shifting were means for achieving additional earnings. Incentive-based regulation not only does not reward such market behavior, but, in addition, deters such behavior because carrier profits would actually decrease.

earnings. Moreover, whether competition developed more or less rapidly than expected has no bearing on earnings under price caps, because the price cap constraint is designed to limit prices to agreed-upon levels whether or not competition imposes additional constraints on prices.

21. All that earnings can suggest about a price cap carrier is an indication of how successfully a firm has been able to compete subject to the regulatory limits on price. Because the price cap established maximum prices (for baskets of services) as part of the regulatory bargain, neither regulatory earnings nor margin (price less incremental cost) for a service can be used to judge whether a given set of service prices are excessive.

**B. Margins Between Price and Incremental Cost Are Not a Measure of Market Power, Nor Do They Show That Prices Are Unreasonable**

22. AT&T uses its petition to play again its old refrain that any departure of price from incremental cost evidences that rates are excessive.<sup>11</sup> AT&T wants the Commission to reset prices, using special access margins as the purported rationale for the Commission to abandon incentive-based regulation. Essentially, AT&T expects the Commission to embrace the precept that only rates set at incremental costs are just, reasonable and nondiscriminatory. What AT&T attempts to portray as the new orthodoxy is merely recycling old regulatory dross. Experience has shown that price cap regulation and pricing flexibility have resulted in lower prices, increased efficiency and substantial infrastructure investment.

23. AT&T promulgates an irrational view that an incremental cost pricing standard emulates a competitive outcome. Economic evidence, however, suggests that non-regulated competitive firms, when faced with significant fixed costs such as those that characterize the telecommunications industry, systematically set their prices in excess of marginal costs.

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<sup>11</sup> AT&T Petition at 11-13.

Permitting market forces to determine the manner in which shared and common costs are recovered results in a set of more efficient prices than would occur if the Commission arbitrarily dictated the allocation of such costs through a cost methodology, irrespective of whether the methodology is called TELRIC, FDC or separations.

24. As Kahn and Taylor confirm, it is not possible to price each telecommunications service at incremental costs and still have a viable firm that prospectively expects to recover all of its forward-looking costs.<sup>12</sup> Moreover, Kahn and Taylor refute AT&T's assertion by demonstrating that special access margins (*i.e.*, the difference between price and incremental costs) do not evidence the existence of either market power or unreasonable rates.

25. Kahn and Taylor explain that prices systematically exceed marginal costs in the face of significant fixed costs. AT&T would not dispute that the domestic residential long-distance telecommunications market is competitive. Yet, Kahn and Taylor's computation of margins in the residential long distance market show that such margins are as large, if not larger, than those objected to by AT&T with respect to special access prices.<sup>13</sup> As Kahn and Taylor conclude:

The point of this example is that in industries, such as telecommunications, characterized by high fixed costs and economies of scale and scope it is neither uncommon nor in itself incompatible with effective (but sustainable) competition to find high percentage markups of price above incremental cost for individual services. . . . Thus, such markups in the special access market three years after limited pricing flexibility began are not in themselves evidence of excessive prices or of the presence of market power.<sup>14</sup>

26. Further, AT&T is simply wrong when it asserts that recent price increases for certain special access services demonstrate that pricing flexibility is not working or that such increases

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<sup>12</sup> Kahn/Taylor Decl. at 10.

<sup>13</sup> *Id.* at 10-11.

<sup>14</sup> *Id.* at 11-12.

are evidence of market power. In the first instance, the only rates that BellSouth increased were month-to-month rates for DS1 and DS3 services. Services that BellSouth must provide on a month-to-month basis represent the services that have the highest transaction costs. Under price cap regulation alone, there is not sufficient flexibility to align rates properly to reflect such transactional differences between term and volume discount plans and month-to-month rates. Pricing flexibility enabled BellSouth to more properly reflect transactional differences by adjusting month-to-month rates.

27. Despite the rate adjustment, substantial discounts off month-to-month rates remain available for DS1 and DS3 services through term plans such as BellSouth's Area Commitment Plan and Transport Payment Plan. Indeed, for DS1 services 97 percent of DS1 revenues are associated with such term plans. Similarly, for DS3 services, 98 percent of DS3 revenues are likewise associated with such discounted rates.<sup>15</sup>

28. In addition to the discounts available under the term plans, BellSouth has negotiated nine contract tariffs that offer customers volume-based discounts. These contract tariffs offer discounts over and above the term plans for a wide range of volumes, from as little as \$2 million annually to over \$80 million annually. BellSouth estimates that by the end of 2002, it will have given contract tariff customers discounts amounting to \$9.5 million.

29. While AT&T seeks to create the impression that the only result of pricing flexibility has been rate increases, the facts demonstrate otherwise. Pricing flexibility has enabled more rational prices to be established, and, as fully anticipated by the Commission, in limited instances the price adjustments included increases. More importantly, pricing flexibility has led to a wide

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<sup>15</sup> The percentages are based on year-to-date 2002 revenues.

range of negotiated offerings, which have introduced not only volume discounts but also service level agreements that guarantee service performance. Thus, pricing flexibility has enabled the marketplace and customers to replace regulators as the determinants of the terms and conditions of transport offerings.

30. Not only has AT&T mischaracterized the experience under pricing flexibility, but its interpretation of special access data is likewise confused. AT&T focuses on the growth of special access revenues and perceives such growth as evidence of market power. None of the analyses accompanying AT&T's petition bother to consider special access demand. Special access volumes have been increasing rapidly. Such increases are consistent with the fact that data services have been growing more rapidly than voice services in recent years. As Kahn and Taylor explain, growth in demand unrelated to price reductions is associated with an outward shift of the demand curve. In these circumstances, the market price will increase, at least in the short run, driven by the demand increase.<sup>16</sup>

31. Further, Kahn and Taylor's analysis shows that, based on the ARMIS data relied on by AT&T, the growth in special access lines fully explains the growth in revenue. Kahn and Taylor find that "the RBOCs' average revenue per line between 1996 and 2001 decreased by more than 1 percent per year in nominal terms and by more than 3 percent per year in constant dollars. Thus, the pricing flexibility exercised by some their during 2001 had no noticeable

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<sup>16</sup> Kahn/Taylor Decl. at 13. Kahn and Taylor conclude that "an increase in prices, revenue and demand volumes is not necessarily evidence that a large firm possesses market power, as AT&T clearly implies. Supply and demand are normally equilibrated in unregulated markets as demand expands by increases in prices and revenue until additional capacity can be brought on line, in reaction to the increased prices." *Id.* at 14.

effect on their special access revenues per line, and AT&T's dire complaints of massive price increases likewise appear to be belied by the data."<sup>17</sup>

32. Lastly, AT&T attempts to infer market power by claiming that the RBOCs' provisioning performance for special access has deteriorated. AT&T's claim is nothing more than the same discredited arguments that AT&T and others have made in the Commission's proceeding that is considering adopting performance measures and standards for special access.<sup>18</sup> The laments regarding service performance presented in the special access performance docket were for the most part anecdotal recitations regarding performance failures (e.g., installation or maintenance) or complaints regarding the ordering process. Amazingly, none of these alleged failures have been pursued via the Commission's complaint process.

33. On the other hand, totally inconsistent with AT&T's argument is the fact that BellSouth includes an installation guarantee for its DS1 and DS3 services<sup>19</sup> and that BellSouth has offered performance guarantees in its contract tariffs. Were AT&T correct, none of these performance enhancements would have materialized. Indeed, as expected in a competitive environment, BellSouth must compete on the basis of its performance. Furthermore, pricing flexibility has enabled customers to obtain packages that balance performance and price in a manner that meets the customer's need. It is another example of the marketplace working hand-in-hand with the Commission's pricing flexibility rules in a competitive environment.

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<sup>17</sup> *Id.* at 15-16.

<sup>18</sup> See *In the Matter of Performance Measures and Standards for Interstate Special Access Services, et al.*, CC Docket No. 01-321, *et al.*, Notice of Proposed Rulemaking, 16 FCC Rcd 20896 (2001).

<sup>19</sup> See BellSouth Telecommunications Inc., Tariff F.C.C. No.1 § 2.4.9.

### **C. The Market for Special Access Is Competitive**

34. AT&T argues that there is no competition for special access.<sup>20</sup> It is remarkable that such an argument would make an appearance in the 21<sup>st</sup> century. Special access competition is not nascent and competitors have been firmly established for over a decade.

35. BellSouth submitted a report on special access competition in connection with its comments in the special access performance proceeding.<sup>21</sup> The report, prepared by The Eastern Management Group (“EMG”), demonstrated that the number of competitors offering special access has grown steadily and dramatically over the last fifteen years. The EMG report concluded that purchasers of BellSouth’s special access services are likely to have multiple choices of competitive alternatives and that the marketplace is able to provide any level of service performance for which there is sufficient demand.

36. More recently, Verizon, SBC, Qwest and BellSouth jointly submitted a UNE Rebuttal Report 2002 in connection with the Commission’s Triennial UNE Review.<sup>22</sup> The UNE Rebuttal Report demonstrated that CLECs have extensively deployed their own interoffice transport and high-capacity loops. As the report shows, CLECs have deployed at least 184,000 route miles of fiber, most of which is used for local transport. Wholesalers, utility companies and interexchange carriers are also supplying local fiber. By the end of 2001, one or more CLECs had obtained fiber-based collocation in BOC wire centers that contain more than half of all

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<sup>20</sup> AT&T Petition at 14-21.

<sup>21</sup> A copy of the report is attached to these comments as Exhibit 2.

<sup>22</sup> UNE Rebuttal Report 2002, submitted by BellSouth, SBC, Qwest and Verizon, October 2002, CC Docket Nos. 01-338, 96-98, and 98-147 (filed Oct. 23, 2002).



business lines served by the RBOCs, and in more than 60 percent of all BOC wire centers that serve over 10,000 business lines.<sup>23</sup>

37. Moreover, CLEC fiber networks reach approximately 30,000 commercial office buildings nationwide. By the end of 2001, CLECs served at least 156 million voice-grade equivalent circuits, the majority of which they provided over high-capacity facilities that they had deployed. Significantly, CLECs purchase only a small number of high-capacity loops from the BOCs, serving the vast majority of their customers with their own last-mile facilities.<sup>24</sup>

38. Not only do these facts belie AT&T's laments, but also AT&T's complaints ignore its capacity to self-supply special access circuits. As Kahn and Taylor note:

Towards the end of the 1990s, consolidation in the telecommunications industry sharply reduced the number of these competitors, and between 1996 and 1998, the three largest consolidated CAPs were further acquired by AT&T and WorldCom . . . . As a result, the capacity (and growth prospects) for competitive wholesale local exchange facilities was taken off the open market and brought in-house by the two largest IXC's (and two of the largest CLECs). Consequently, there are fewer *independent* CAPs available to AT&T and WorldCom today when they seek alternatives to RBOC special access circuits; but, of course, the capacity of AT&T and WorldCom to supply these facilities themselves increased by the same amount. One cannot simultaneously acquire the major wholesale providers of special access circuits and then, invoking the orphan defense, complain about a shortage of independent supplies or suppliers on the open market!<sup>25</sup> (emphasis in original)

39. Another argument advanced by AT&T to disparage the competitive special access market is that special access is characterized by economies of scale and sunk costs that simply

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<sup>23</sup> UNE Rebuttal Report 2002 at 39-40.

<sup>24</sup> *Id.* at 44.

<sup>25</sup> Kahn/Taylor Decl. at 24.

cannot be replicated.<sup>26</sup> Kahn and Taylor point out that AT&T is replaying an old theme.<sup>27</sup> Special access transport and channel terminations are point-to-point, not switched, and it is not necessary to duplicate a LEC's network in order to participate successfully as a supplier of dedicated circuits. Kahn and Taylor also note that the main driver of scale economies for local exchange service – customer density – is “less important for dedicated transport or other point-to-point circuits, which do not use switches and for which individual customer locations provide a high volume of usage.”<sup>28</sup> Finally, Kahn and Taylor put to rest AT&T's claim that the large marketing expenditures necessary to establish a brand act as a barrier to entry in the special access market. As Kahn and Taylor explain, marketing and promotional expenditures are less important for wholesale special access services than retail services. In any event, while a new CLEC might incur higher costs than an RBOC to establish a brand, that condition would hardly apply to AT&T, who already has business relationships with many customers and long ago established brand and name recognition.<sup>29</sup>

**D. Special Access Pricing Flexibility Does Not Impede Competition**

40. AT&T reprises its claim that special access pricing flexibility impedes competition both in the local exchange market and in the long distance market.<sup>30</sup> With regard to the local market, AT&T's complaint is with the use and commingling restrictions that apply to UNEs. According to AT&T, because of these restrictions, CLECs cannot connect their transport or switch facilities except by buying special access rather than UNEs priced at TELRIC rates.

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<sup>26</sup> AT&T Petition at 16-17, 29-30.

<sup>27</sup> Kahn/Taylor Decl. at 25.

<sup>28</sup> *Id.* at 25-26.

<sup>29</sup> *Id.* at 26-27.

<sup>30</sup> AT&T Petition at 16-18.

41. The access market is separate and distinct from the local exchange market. Before UNEs can be used in the access market, the Commission must conduct a separate impairment analysis focusing on the special access services marketplace. The fact that competition is thriving in the exchange access market, particularly in the market for competitive special access services, belies any argument of impairment. The customer base for special access services is composed of a relatively few large entities located in geographically concentrated areas – with some 80 percent of ILEC special access revenues being generated from fewer than 25 percent of the wire centers.<sup>31</sup> These characteristics differ markedly from those of mass-market local exchange services. In addition, the facilities used to provide special access services are different from those used to provide local exchange services to individual consumers, typically comprising high-capacity non-switched circuits. Consequently, the nature of the special access market enables competitors, such as AT&T, to enter the market and expand through targeted investments.

42. To leave none of its old arguments out, AT&T again raises the specter of the LECs engaging in a price squeeze as they enter the interexchange market.<sup>32</sup> The alleged problem would arise from a LEC charging IXCs access prices above forward-looking economic costs, while the LEC's long distance affiliate would be able to price its retail long distance services taking into account only the incremental cost the LEC incurs in providing access. Using the lower access cost, the LEC then would be able to charge a lower retail long distance price.

<sup>31</sup> Moreover, as Kahn and Taylor point out, the economics of AT&T's argument that special access prices inhibit facilities-based competition do not work. Because special access is a factor of production, forcing special access prices down, as AT&T wants the Commission to do, would lead to more intensive use of that factor which would mean *less*, not more, facilities-based competition. Kahn/Taylor Decl. at 27-28.

<sup>32</sup> AT&T Petition at 23-24.

Competitors claim that they would be forced either to match the price reduction and absorb profit margin reductions or maintain their prices at existing levels and accept reductions in their market share.

43. The price squeeze allegation is unfounded given the existing statutory requirements. The supposed conundrum an IXC would face in deciding whether to accept reduced profit margins or reduced market share is nothing more than a reflection of the fact that, if LEC affiliates start to provide long distance service, their entry will likely lead to downward pressure on long distance prices. This result, however, is procompetitive and benefits consumers.

44. As long as a LEC long distance affiliate prices long distance service at or above the sum of the access price level plus the additional incremental costs the LEC affiliate incurs providing long distance service, there is no legitimate complaint about the LEC's pricing, and there is no price squeeze. A price squeeze involves the situation where a supplier of an input that is essential for competitors to purchase prices the input and its own competing retail service at levels that would cause an equally efficient competitor to exit the market. Because, by definition, the LEC long distance affiliate is covering all of its incremental costs if it charges a retail price at or above the sum of the price it pays its affiliate for access, plus the additional incremental costs of providing long distance, it would not exit the market, nor would an equally efficient competitor. As the Supreme Court noted in *Brooke Group v. Brown & Williamson*, "above-cost prices that are below general market levels or the cost of a firm's competitors" are not considered anticompetitive under the antitrust laws.<sup>33</sup> The *Brooke Group* Court also noted that "[a]s a general rule, the exclusionary effect of prices above a relevant measure of cost either

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<sup>33</sup> 509 U.S. 209, 223 (1993).

reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price-cutting.”<sup>34</sup>

45. Existing statutory requirements prohibit the sort of anticompetitive pricing feared by AT&T. Section 272(e)(3) requires the LEC long distance affiliate to purchase (or the LEC to impute to itself if it is providing long distance service) access at rates no lower than those rates offered to others, and Sections 201 and 202 prohibit the LEC or LEC long distance affiliate from pricing below incremental cost. In addition to being prohibited, the type of pricing that is at the root of AT&T’s anxiety would easily be detected, since access prices are known, and LEC long distance affiliates are subject to biannual audits.

46. AT&T also complains that special access pricing flexibility, with its optional pricing plans, impedes competition. At the outset, optional pricing plans for special access long preceded the pricing flexibility rules. Discounts had been available for term commitments and volume commitment as far back as 1991. Indeed, the issue of “fresh-look” was addressed by the Commission in its transport expanded interconnection order in 1993.<sup>35</sup> The fact of the matter is that the presence of LEC optional pricing plans did not impede the development of robust facilities-based competition in the special access market in the 1990’s and it does not do so now.

47. Moreover, the use of optional pricing plans is consistent with a competitive market. As Kahn and Taylor observe:

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<sup>34</sup> *Id.*

<sup>35</sup> *In the Matter of Expanded Interconnection with Local Telephone Company Facilities and Amendment of part 36 of the Commission’s Rules and Establishment of a Joint Board*, CC Docket No. 91-141, Transport Phase I, and CC Docket No. 80-286, *Second Report and Order and Third Notice of Proposed Rulemaking*, 8 FCC Rcd 7374 (1993).

Any carrier precluded from offering optional pricing plans with term and volume discounts would be placed at a significant competitive disadvantage in the special access market. Long-term contracts are used to minimize risk exposure and stabilize production requirements and costs over time. In addition, when the buyer or seller incurs heavy sunk costs as part of the transaction, both parties are better off under effective long-term contracts. Common examples of such costs in special access markets include network design of customer-specific facilities and the purchase of transaction-specific equipment and facilities. Under such contracts, the buyer and seller are both assured that (i) their sunk costs will eventually be recovered from the transaction for which the costs were incurred and (ii) up-front sunk costs can be amortized and recovered over the life of the transaction, better aligning costs with revenues. Long-term contracts thus have salutary effects in the form of risk and cost reduction, both for suppliers and customers.<sup>36</sup>

48. The optional pricing plans are in fact optional. Nothing compels AT&T to subscribe to such a plan. AT&T complains that the only way to obtain discounts is to commit to the term or volumes of such plans. AT&T simply chooses to ignore the fact that the discounts are associated with the efficiencies associated with the commitments (*e.g.*, planning efficiencies, transactional, efficiencies etc.) Instead, as Kahn and Taylor observe, "AT&T wants to have its cake and eat it: it values the savings from RBOC OPPs but complains about the penalties that apply for early termination. . . . Obviously, if a customer could sign a long-term contract, obtain a discounted price on the expectation that the contract will be fulfilled, and then breach the contract without consequences if a better offer came along, such contracts, with the benefits they offer both parties, would be simply infeasible in the first place and end user customers would, ultimately, be the losers."<sup>37</sup> If LECs cannot depend on the carrier meeting the terms and conditions associated with the optional pricing plan, then the LEC would not be able to offer any

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<sup>36</sup> Kahn/Taylor Decl. at 31-32.

<sup>37</sup> *Id.* at 32-33.

form of discounts – and everyone loses – the LEC, the carrier and ultimately the end user consumer. Such an outcome is hardly procompetitive or in the public interest.

### **III. CONCLUSION**

49. AT&T's petition presents no evidence that pricing flexibility has failed or resulted in unexpected outcomes. In these comments, BellSouth has shown that there has been no identifiable harm to the competitive process by the Commission's pricing flexibility rules. Despite AT&T's laments, competition continues to grow.

50. AT&T's petition represents a patchwork of every argument that AT&T has made to stymie regulatory reform for LECs. While retro-music, clothes and cars may be chic, retro-regulation is not the way to establish public policy or the proper foundation for telecommunications in the 21<sup>st</sup> century. The Commission has recognized that its challenge is to harness the economic power of the marketplace and to permit the marketplace to be the engine of change and advancement in the telecommunications industry. This understanding pre-dates the passage of the Telecommunications Act of 1996 and, with the Telecommunications Act's emphasis on deregulation, confirms the Commission's choice of a market-oriented regulatory approach. Pricing flexibility is merely one facet in the Commission's market-based arsenal. It is working, and AT&T has not shown otherwise.

51. Accordingly, the Commission should deny AT&T's petition for rulemaking.

Respectfully submitted,

**BELLSOUTH CORPORATION**

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Date: December 2, 2002



# **Comments of BellSouth**

**RM No. 10593**

**December 2, 2002**

**Exhibit 1**

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554**

In the Matter of	)	
	)	
AT&T Corp.	)	RM No. 10593
	)	
Petition for Rulemaking to Reform	)	
Regulation of Incumbent Local Exchange	)	
Carrier Rates for Interstate Special	)	
Access Services	)	

**Declaration of  
Alfred E. Kahn and William E. Taylor  
On Behalf of  
BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and  
Verizon**

**SUMMARY**

Competition in the special access market is vigorous and growing. Even in an environment in which RBOC local service volumes are declining and market valuations of telecommunications firms have collapsed, local exchange competition and competition for special access services continue to expand. Retraction of pricing flexibility for RBOC special access services as AT&T demands is not only unnecessary; it would weaken competition.

In contrast to AT&T's litany of familiar complaints about the prematurity of pricing flexibility and its dependence on RBOC facilities and services, we observe that the competitive supply of special access services has steadily increased with no observable slowdown from the implementation of limited special access pricing flexibility in 2001 and 2002. Competitive fiber route miles roughly doubled each year between 1990 and 1995, increasing from about 500 route miles to about 21,000, and current estimates put CLEC fiber networks at approximately 100,000 route miles in 1999 and 184,000 in 2002. Geographic coverage increased correspondingly; there are now

nearly 2,000 CAP networks in the largest 150 MSAs, and the top 25 MSAs average over 32 CLEC networks in *each*. Several independent estimates put the current CLEC share of special access revenues—not including the very large extent to which such CLECs as WorldCom and AT&T supply their own needs—at approximately 30 percent, and that share has continued to increase since the RBOCs were permitted flexibility in pricing of these special access services. On the retail side, the three largest IXC's still dominate the market for large business customers (the “enterprise business market”), which is the largest retail market that uses special access as an input. That fact demonstrates that IXC's can successfully compete in one of the most competitive retail markets, relying on some combination of self-supply, competitive supply and RBOC supply of the requisite special access facilities.

The principal putative facts that AT&T cites in support of its complaint center around the level and growth of RBOC special access rates of return and price-cost margins. Rates of return for individual services based on fully distributed costs are, however, notoriously meaningless as measures of anything, a fact upon which we and AT&T's economists have, until now, been in complete agreement. Similarly, price-cost margins measured using TELRIC are not evidence of market power: blank-slate TELRIC does not approximate RBOC forward-looking incremental costs and even properly-calculated price-cost margins need not be small in competitive markets where fixed and common costs are important, as they undoubtedly are in the telecommunications market. Indeed, evidence from AT&T's pricing of long distance service three years after it was granted full pricing flexibility shows margins as large or larger than those of which it complains here. Finally, the facts contradict AT&T's theories. The RBOCs' average revenue per line between 1996 and 2001 decreased by more than 1 percent per year in nominal terms and by more than 3 percent per year in constant dollars. Over the same period, trouble reports per access line fell, and the percentage of installation order commitments met remained consistently high. Nothing in the data remotely suggests the exercise of market power, whether by increasing prices or allowing service quality to deteriorate.

This is no evidence on which to reverse the Commission's long-standing policy of adapting regulatory constraints to the degree of competition in the market. Reducing the

RBOCs' ability to price services flexibly in markets where competitors have already constructed facilities and incurred sunk costs would only hamstring one of the larger participants in the market and deny customers—wholesale and retail—the benefits of vigorous competition.

**Declaration of  
Alfred E. Kahn and William E. Taylor  
On Behalf of  
BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and  
Verizon**

**I. Qualifications**

My name is Alfred E. Kahn. My business address is 308 N. Cayuga Street, Ithaca, NY 14850. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, Cornell University and Special Consultant with National Economic Research Associates, Inc. (NERA). I received my A.B. degree summa cum laude from New York University and my Ph.D. from Yale University, in 1942. I came to Cornell University in 1947 and have served successively as Chairman of the Department of Economics and Dean of the College of Arts and Sciences. I have been Chairman of the New York State Public Service Commission and of the (U.S.) Civil Aeronautics Board; and in my capacity as Advisor to President Carter on Inflation, I participated actively in the successful efforts of his Administration to deregulate the trucking industry.

I am the co-author of *Fair Competition, The Law and Economics of Antitrust Policy*, author of the two-volume *The Economics of Regulation*, reprinted in 1988 by MIT Press, *Letting Go: Deregulating the Process of Deregulation*, published in 1998 by Michigan State University Institute of Public Utilities, *Whom the Gods Would Destroy or How Not to Deregulate*, published last year by the AEI-Brookings Joint Center for Regulatory Studies, and have published and testified extensively over the last twenty years in the area of direct economic regulation and deregulation, and on the requisites of efficient competition in regulated and previously regulated industries. I served as Associate Economist with the Antitrust Division of the U.S. Department of Justice in 1941-42; as a member of AT&T's Economic Advisory Board in 1968-74; was a member of the Attorney General's National Committee to Study the Antitrust Laws and the National Commission on Antitrust Laws and Procedures in the Eisenhower and Carter Administrations, respectively; I have served as consultant with both the Antitrust Division of the Department of Justice and the Federal Trade Commission; I was recently

a member of the National Research Council – Transportation Research Board committee charged with reporting to Congress on the state of competition in the airline industry.

My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc., head of its Communications Practice, and head of its Cambridge office located at One Main Street, Cambridge, Massachusetts 02142.

I have been an economist for over twenty-five years. I earned a Bachelor of Arts degree from Harvard College in 1968, a Master of Arts degree in Statistics from the University of California at Berkeley in 1970, and a Ph.D. from Berkeley in 1974, specializing in Industrial Organization and Econometrics. For the past twenty-five years, I have taught and published research in the areas of microeconomics, theoretical and applied econometrics and telecommunications policy at academic and research institutions including the Economics Departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology. I have also conducted research at Bell Laboratories and Bell Communications Research, Inc. I have appeared before state and federal legislatures, testified in state and federal courts, and participated in telecommunications regulatory proceedings before state public utility commissions, as well as the Canadian Radio-television Telecommunications Commission, the Mexican Federal Telecommunications Commission and the New Zealand Commerce Commission. I have also filed studies before the Federal Communications Commission on numerous occasions. Of particular relevance to the present docket were a series of five filings with Professor Richard Schmalensee between 1994 and 1998 in CC Docket Nos. 94-1 and 96-262 on the use of observable triggers to determine when markets were sufficiently competitive to warrant pricing flexibility and the application of those triggers to special access markets.

## **II. The Special Access Market Remains Vigorously Competitive.**

Special access services are private line services, i.e., services or facilities dedicated to a single customer. Special access channel terminations are sold to long distance carriers ("IXCs") to originate or terminate interstate networks generally built for large business customers, and special access transport to connect the IXCs' or CLECs' points of presence ("POPs") with the local exchange carrier's central offices. Special

access services are also sold directly to large business customers, typically as part of private networks.

**A. Competition in the special access market is well-developed.**

Competition for special access services is as old as the RBOCs. Taking advantage of the regulatorily-imposed markups above marginal or book costs incorporated in RBOC interstate and intrastate carrier access charges, as a contribution to recovery of fixed and common costs, including the deliberate subsidization of basic residential charges, Teleport (TCG) began providing bypass services to IXC's and business customers in lower Manhattan in 1984, shortly after the divestiture of the Bell System. Additional entry and expansion followed rapidly, as Institutional Communications Company (ICC) entered the Washington, DC market in 1986 and Chicago Fiber Optic followed shortly with an optical fiber network in Chicago. Between 1984 and 1992, competitive access providers ("CAPs") proliferated, constructing fiber rings in the business districts of large and medium-sized cities, primarily providing dedicated connections between large business customers and their IXC's in order to avoid the regulated carrier access charges. In 1992, incumbent LECs were required to provide collocation in their central offices to CAPs, and CAP networks responded by building facilities between IXC POPs and collocation facilities in LEC central offices, opening the market for transport to competition.<sup>1</sup>

Demand for CAP services grew rapidly. CAP fiber route miles roughly doubled each year between 1990 and 1995, increasing from about 500 route miles to about 21,000, and current estimates of CLEC fiber networks total approximately 100,000 route miles in 1999 and 184,000 in 2002. Geographic coverage increased correspondingly; there are now nearly 1,800 CAP networks in the largest 150 MSAs, and the top 25 MSAs average over 32 CLEC networks in *each*.<sup>2</sup> Independent sources put the current CLEC share of special access revenues at more than 30 percent, and that share has continued to

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<sup>1</sup> See "Competition For Special Access Services" filed as Attachment B to Opposition of Verizon in this proceeding on December 2, 2002 ("2002 Special Access Fact Report") at 7.

<sup>2</sup> 2002 Special Access Fact Report at 12-13.

increase since the RBOCs were permitted flexibility in pricing of these special access services.<sup>3</sup>

On the retail side, the three largest IXC's still dominate the market for large business customers (the "enterprise business market"), which is the largest retail market that uses special access as an input. That fact demonstrates that IXC's can successfully compete in one of the most competitive retail markets, relying on some combination of their own special access facilities and those of the other competitive suppliers and the RBOCs.

**B. The FCC's triggers for pricing flexibility are reasonable and have been successful in application.**

Against this background of established and proliferating facilities-based competition, the FCC embarked on a measured transition path towards pricing freedom for special access services as competition developed. Upon divestiture, LECs were permitted limited pricing flexibility in the form of optional volume discounts for private line and special access services, in recognition of the growing competition for those services.<sup>4</sup> In transitioning to price cap regulation in 1990, the FCC authorized additional flexibility in the form of relaxed pricing rules in the special access basket, and those rules were gradually loosened over the next five years, permitting more extensive term and volume discounts and prices deaveraged by density zone.<sup>5</sup> After the Telecommunications Act of 1996 opened the local and long distance markets to additional competition, the FCC reassessed the special access pricing rules, and in August 1999 adopted the Fifth Report and Order in CC Docket No. 96-262, which outlined circumstances under which suppliers of price-cap-regulated access services would be permitted additional pricing flexibility. The intention of the Order was to

allow[] competition rather than regulation, to determine prices for interstate access services, thus providing customers more choices among services, carriers, and rates. The Order gives the nation's largest telephone companies progressively greater flexibility in setting interstate

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<sup>3</sup> 2002 Special Access Fact Report at 27-28.

<sup>4</sup> Report and Order, *Private Line Structure and Volume Discount Practices*, 97 FCC 2d 923 ¶39 (1984).

<sup>5</sup> Second Report and Order, *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786 (1990) and First Report and Order, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961 (1995).



rates as competition develops, gradually replacing regulation with competition as the primary means of setting prices.<sup>6</sup>

Among other reforms, the Order established a two-phased framework for granting specific forms of pricing flexibility, along with objective triggers that measured the degree to which competition had developed in specific geographic markets. In general, if competitors have collocated and use competitive transport in a target percentage of a price cap LEC's wire centers (or wire centers accounting for a target percentage of the LEC's revenue) in an MSA, the LEC's special access services are entitled to either Phase I or Phase II relief, depending on the trigger attained.

Phase I relief permitted the LEC to offer contract tariffs and volume and term discounts on one day's notice; Phase II relief removed the price caps entirely. More stringent triggers were set for obtaining Phase II relief than for Phase I and for relief applying to channel terminations than to transport. Beginning in the Fall of 2000, the LECs applied for such flexibility, and the first petitions were granted in December.<sup>7</sup> Additional petitions followed in 2001 and 2002.

These rules represent a reasoned and measured transition from a regime in which regulation constrains prices towards one in which prices are constrained only by competitive forces. Properly, they tailor the degree of pricing flexibility to the geographic differences in the rate at which CAPs, IXC's and CLEC's invest and build their own competitive facilities—specifically, to the proportion of wire centers in an MSA in which competitors have made sunk investments in their own facilities.<sup>8</sup> The presence of such investments indicates the need for pricing flexibility because it shows that—in the wire center in question—the market is open and entry barriers are sufficiently low that some firms are actually investing in sunk assets. Such committed entry is also a powerful deterrent to anticompetitive pricing by incumbent LECs because, once installed, the facilities would remain even if the original owner could be driven from the market.

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<sup>6</sup> FCC News, Report No. 99-33, "Commission Adopts Pricing Flexibility and Other Access Charge Reforms," August 5, 1999.

<sup>7</sup> BellSouth Petition for Pricing Flexibility for Special Access and Dedicated Transport Services, CCB/CPD No. 00-20, Memorandum Opinion and Order, 15 FCC Rcd 24588, (Dec. 15, 2000).

<sup>8</sup> In fact, the FCC's triggers underestimate the amount of sunk competitive investment in each wire center because they focus on collocation and ignore investment and competition that makes no use of RBOC facilities at all!

The Commission explicitly expounded the economic logic in its decision. Competitors who collocated in a wire center almost always constructed transmission facilities that terminated in the collocation cage.<sup>9</sup> Once competitors had made such irreversible investments, there was no need for protection against possible ILEC anticompetitive pricing because it was unlikely to succeed.<sup>10</sup> Entry in one wire center in an MSA was an effective trigger for competition throughout the MSA because carriers enter the market on an MSA basis and special access customers are large, sophisticated businesses with bargaining power sufficient to prevent the exercise of ILEC market power in parts of the MSA in which competitive facilities are absent.<sup>11</sup> Moreover, the effect of using collocation as the trigger mechanism was likely to be conservative because it ignored the presence of competitors that completely bypassed the ILECs' facilities.<sup>12</sup>

### **III. AT&T Offers No Valid Evidence of Excessive ILEC Market Power or Insufficiently Effective Competition.**

AT&T provides no valid economic evidence that RBOCs retain significant market power in special access markets. Its use of accounting profit rates as we will proceed to explain, based on fully distributed costs to demonstrate that individual services are

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<sup>9</sup> "the presence of an operational collocation arrangement in a wire center almost always implied that a competitor has installed transmission facilities to compete with the incumbent," Fifth Report And Order And Further Notice Of Proposed Rulemaking, CC Docket Nos. 96-262, 94-1, 98-63 and 98-157, released: August 27, 1999 ("Fifth Report and Order") at ¶82.

<sup>10</sup> "Phase I of our pricing flexibility framework provides incumbent LECs with regulatory relief when competitors have made irreversible investments in facilities within a given MSA. At that point, we no longer need to protect competition from exclusionary pricing behavior by incumbent LECs, because efforts to exclude competitors are unlikely to succeed" Fifth Report and Order at ¶77.

<sup>11</sup> "...regulatory relief is warranted ... even though such relief might lead to higher rates for access to some parts of an MSA that lack a competitive alternative, for several reasons. First, the customers for the services we address in this section are IXCs and large businesses, not residential or small business end users. These large and sophisticated customers generate significant revenues for the incumbent and are not without bargaining power with respect to the incumbent. Second, delaying Phase II regulatory relief until access customers have a competitive alternative for access to each and every end user might give competitors the ability to "game the system." In other words, competitors might be able to prevent an incumbent from obtaining pricing flexibility in an MSA simply by choosing not to enter certain parts of that MSA or to serve certain customers. We will not distort the operation of the market in this manner. Finally, because regulation is not an exact science, we cannot time the grant of regulatory relief to coincide precisely with the advent of competitive alternatives for access to each individual end user. We conclude that the costs of delaying regulatory relief outweigh the potential costs of granting it before IXCs have a competitive alternative for each and every end user." Fifth Report and Order at ¶¶142-144.

<sup>12</sup> "evidence of collocation may underestimate the extent of competitive facilities within a wire center, because it fails to account for the presence of competitors that do not use collocation and have wholly bypassed incumbent LEC facilities" Fifth Report and Order at ¶95.

overpriced is economic nonsense. Similarly, inferring the presence of market power from price-cost margins—particularly where the cost measure employed is TELRIC—has no valid economic basis. Finally, AT&T’s claim that increases in special access prices and revenues imply the absence of competitive alternatives for customers is incorrect as a matter of both fact and principle.

**A. Earnings derived from measures of fully allocated costs cannot be used to justify a reduction in pricing flexibility.**

AT&T says that high accounting rates of return for RBOC interstate special access services “represent conclusive proof of the Bells’ overwhelming market power.”<sup>13</sup> This is a truly outrageous claim, relying as it does on measures of fully allocated book costs of services whose production in common with others entails a very high proportion of fixed and common costs and significant economies of scope—all the more so coming from a company and specific witnesses who have consistently and correctly decried the basis for such claims in economic terms for many decades. Yet, in this case, Drs. Ordoover and Willig surprisingly, without comment, equate ARMIS regulated rates of return for special access with economic profits (at ¶24), even adjusting them upward on the ground that “the RBOCs’ true costs of providing services over their local networks are their much lower forward-looking economic costs” (at ¶26) and by so doing enjoying the best of both possible worlds—regulatory allocations of costs themselves lower than regulatory costs, as typically measured.

High or increasing rates of return calculated using regulatory cost assignments for interstate special access services do not in themselves indicate excessive economic earnings reflecting the exercise of market power. Indeed, regulatory rates of return for geographic subsets of single services in multi-product, multi-geographic firms bear no relationship with economic profits and thus can serve no useful purpose in determining whether pricing flexibility has or has not been excessively permissive. ILECs are integrated multi-regional firms and rely on an integrated regional management structure employing the regional physical and human resources to provide a multiplicity of services. The cost allocations required render such a calculation meaningless.

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<sup>13</sup> AT&T Corp., Petition for Rulemaking To reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services, RM 10593, October 15, 2002 (“Petition”), at 8.

Indeed, AT&T presented this very argument to regulators in Massachusetts when requesting to be relieved of rate of return regulation for intrastate services:

AT&T is an integrated, multijurisdictional company providing telecommunications services worldwide using an integrated national management structure and employing the same physical and human resources to provide international, interstate and intrastate services. Because AT&T's services used the same network, computers and other facilities whatever the jurisdiction, determining a cost basis for calculating an economically meaningful rate of return is impossible. Rationally determining the cost basis for purposes of pricing individual state subsets of those services is also an economically impossible task. Yet, Massachusetts ROR regulation requires that a fully-allocated cost basis be established and that the prices for AT&T's intrastate services be modified to reflect such cost allocations. Allocating AT&T's multistate costs to determine AT&T's Massachusetts costs, further allocating those costs between interstate and intrastate services, and yet further allocating the intrastate costs among numerous intrastate services is economically irrational as a basis for setting prices. There is no rational basis for believing that rates based on fully allocated costs are either fair or economically justified.<sup>14</sup>

The same considerations that led AT&T to contend that rates of return based on allocated accounting costs are "economically irrational" as a basis for pricing apply equally to RBOC interstate special access. The allocations of RBOC accounting costs between regulated and unregulated intrastate and interstate services are, of necessity, not based on cost-causation. Among interstate services, the allocation of costs to special access services requires additional, similarly arbitrary assumptions. The sources of these difficulties are obvious. Fixed and common costs permeate—indeed dominate—a telephone company's cost structure: to offer a single example, Executive and Planning plus General and Administrative Expenses represents more than 11 percent of Total Operating Expenses for the RBOCs.<sup>15</sup> Even more important, each RBOC's network provides interstate and intrastate services, carrier services (special and switched access) and retail services (local and toll): a large fraction of these network costs cannot be assigned on a cost-causal basis to individual services.

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<sup>14</sup> Initial Brief of AT&T Communications of New England, Inc., dated April 23, 1992, in the Commonwealth of Massachusetts Department of Public Utilities proceeding DPU 91-79, at 42-43. Citations omitted.

<sup>15</sup> In the 2001 RBOC ARMIS 43-02 report, the relevant expenses accounts are Executive and Planning (6710), General & Administrative (6720) and Total Operating Expenses (720).

The regulatory expedient of assigning fixed costs among categories (e.g., between regulated and unregulated or between interstate and intrastate jurisdictions), in proportion to variable costs or demand volumes, though "reasonable," is not cost-causative, and the resulting costs are not economic costs. It might be equally reasonable to allocate railroad overhead costs to services by volume, weight or value, but shippers of feathers, coal and diamonds would undoubtedly disagree about the results. In Dr. Willig's prophetic words some 15 years ago,

Fully allocated cost figures and the corresponding rate of return numbers simply have zero economic content. They cannot pretend to constitute approximations to *anything*. The "reasonableness" of the basis of allocation selected makes absolutely no difference except to the success of the advocates of the figures in deluding others (and perhaps themselves) about the defensibility of the numbers. There just can be no excuse for continued use of such an essentially random, or, rather, fully manipulable calculation process as a basis for vital economic decisions by regulators.<sup>16</sup>

**B. Margins between price and incremental cost are not a measure of market power for telecommunications services.**

AT&T asserts (Petition at 10) that the markup above incremental costs for special access services is unreasonable and much higher than markups in competitive markets.<sup>17</sup>

Special access services are provided over the same facilities and are functionally equivalent to high capacity loop and transport network elements. Yet, the Bell's month-to-month special access rates are generally double...their comparable UNE rates.<sup>18</sup>

Both the comparison and the inference drawn from it are absurd.

First, where margins between price and incremental cost are used to measure anything, the incremental cost in question is emphatically never TELRIC. For example, the familiar Lerner index (the percentage markup of price above incremental cost) is sometimes calculated for a firm, but the incremental cost in question is the forward-looking economic cost of the firm itself, not the hypothetical cost of a perfectly efficient

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<sup>16</sup> W. J. Baumol, M. F. Koehn and R.D. Willig, "How Arbitrary is 'Arbitrary'? – or, Toward the Deserved Demise of Full Cost Allocation," *Public Utilities Fortnightly*, Vol. 120, No. 5, September 3, 1987 at 21.

<sup>17</sup> Also see the Declaration of Janusz A. Ordovery and Robert D. Willig on Behalf of AT&T Corp. filed as Tab B to the Petition. ("O-W Declaration") at 12.

firm serving the entire market as a wholesale provider using a fully-modern network optimally deployed around the incumbent firm's existing switch locations. Second and more fundamentally, price markups above incremental cost are necessary in an industry like telecommunications that is characterized by a large proportion of shared and common costs, fixed and variable. It is well-understood in the industry that it is not possible to price each telecommunications service at incremental costs and still have a viable firm that can expect to recover all of its forward-looking costs.

Experience from other segments of the industry clearly demonstrates that in the face of significant fixed and common costs, prices systematically exceed marginal costs. For example, the domestic residential long-distance telecommunications market has often been considered to be reasonably competitive, and AT&T was declared to be nondominant in that market by the FCC in 1995. Three years later, margins in that market were, however, as large or larger than those cited as "obscene" by AT&T (Petition at 3) for RBOC special access margins today—three years after they were accorded more limited flexibility.

For July 1998, using a public database of telephone bills of a random sample of U.S. residential households, we measured the average rate per minute actually paid by AT&T's customers for interstate domestic direct-dial phone calls, including a per-minute assignment of service charges, promotional credits, fixed monthly PICC flow-through charges, and a fixed monthly universal service fund assessment.<sup>19</sup> From this sample, the average rate paid by AT&T residential customers was about 20 cents per conversation minute. Switched interstate access charges were about 2.8 cents per conversation minute in July 1998.<sup>20</sup> We have estimated that, at that time, federal universal service fund assessments and the Primary Interexchange Carrier Charge ("PICC") paid by AT&T to

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<sup>18</sup> Petition at 10 and O-W Declaration at 12. It is unclear whether to attribute this opinion to AT&T or to its independent economic experts, because—except for a typographic error in the AT&T Petition—they appear identically and without attribution in both the Petition and the O-W Declaration.

<sup>19</sup> W. Taylor and P. Brandon, "Assessment of AT&T's Study of Access Charge Pass-Through," study of long distance pricing, filed ex parte on behalf of the United States Telephone Association, (CC Docket No. 96-262), October 22, 1998 ("Taylor-Brandon"). These calculations use residential billing data from *MarketShare Monitor*<sup>TM</sup>, *op. cit.* They allocate domestic direct-dialed calling-plan subscription charges, service charges, and promotional credits between interstate and intrastate direct-dialed calls. The PICC and universal service charges are interstate.

<sup>20</sup> Taylor-Brandon, and Federal Communications Commission, "Universal Service Monitoring Report", CC Docket No. 98-202 (September 2000), Table 7.15.

serve its residential customers, when added to access charges, came to about 6 cents per conversation minute.<sup>21</sup> Estimates of long distance network marginal cost vary between 1 and 2 cents per conversation minute and total about 5 cents per minute if one includes marketing expenses.<sup>22</sup> Combining these estimates, AT&T's marginal costs of serving residential customers totaled 7 to 11 cents per conversation minute, depending on whether one includes marketing expenses. Thus, AT&T's margin from residential customers was at least 9 cents per minute, even if one includes marketing expenses ( $20 - 11 = 9$ ), and uses the upper range of estimated network costs. Thus three years after receiving considerably more pricing flexibility than the RBOCs received three years ago, AT&T, in the residential long-distance market that is frequently asserted to be competitive, appears to have imposed a minimum markup of almost 82 percent (9 relative to 11 cents) or a markup of more than 185 percent if marketing costs are not treated as incremental.

The point of this example is that in industries, such as telecommunications, characterized by high fixed costs and economies of scale and scope, it is neither uncommon nor in itself incompatible with effective (but sustainable) competition to find high percentage mark-ups of price above incremental cost for individual services. The case made by Drs. Baumol, Panzar and Willig for the importance of contestability as a measure of the effectiveness of competition rests precisely on the inapplicability of the pure or perfect competition model, in which alone there can be no such markups.<sup>23</sup>

<sup>21</sup> In July 1998, the residential PICC was \$0.95 for the first line and \$1.77 for each additional line. *See id.*, Table 7.14. The universal service fund ("USF") assessment was 3.93 percent. *See* Federal Communications Commission, Public Notice, *Proposed Third Quarter 1999 Universal Service Contribution Factors*, CC Docket No. 96-45, DA 99-1091, June 4, 1999. We have calculated AT&T's average cost of the PICC and USF per minute of serving its residential customers using a sample of residential bills from Market Facts, Inc. and PNR and Associates, Inc., *MarketShare Monitor*<sup>TM</sup> (September 9, 1998).

<sup>22</sup> Estimates of toll and access incremental costs are presented in Robert W. Crandall, *After the Breakup: U.S. Telecommunications in a More Competitive Era* (Washington D.C.: The Brookings Institution, 1991), at 138-141; Lewis J. Perl and Jonathan Falk, "The Use of Econometric Analysis in Estimating Marginal Cost," Presented at Bellcore and Bell Canada Industry Forum, San Diego, California (April 6, 1989), Table 2; Robert W. Crandall and Leonard Waverman, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications* (Washington D.C.: The Brookings Institution, 1996); and Paul W. MacAvoy, *The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services* (Cambridge, Massachusetts: The MIT Press and Washington D.C.: The AEI Press, 1996). The costs are obviously averages and vary a great deal across jurisdictions, times of day and technologies.

<sup>23</sup> W.J. Baumol, J.C. Panzar and R.D. Willig, *Contestable Markets and the Theory of Industry Structure*, San Diego: Harcourt Brace Jovanovich, 1982.

Thus, such markups in the special access market three years after limited pricing flexibility began are not in themselves evidence of excessive prices or of the presence of market power.

**C. AT&T misinterprets demand, price and revenue changes in the special access market.**

In both its Petition (at 11) and O-W Declaration (at ¶33), AT&T infers that RBOCs possess market power for special access services from its claim that the special access price increases (cited in Mr. Stith's Declaration) have led to higher revenues. While RBOC special access revenues have indeed increased, the reason is not inelasticity of demand but simply rapid growth in the demand for such circuits. The same ARMIS data sources that Mr. Friedlander uses readily show that special access volumes, measured by the sum of analog and digital access lines, have increased rapidly throughout the late 1990s, while RBOC special access revenue per circuit has declined, not increased.

These data clearly show a rapid and accelerating growth of RBOC special access lines, averaging 30 percent per year over the 1996-2001 period, which is consistent with the conventional industry wisdom that data services have been growing much faster than voice services in recent years.<sup>24</sup> Other sources show comparable growth rates for both ILECs and CLECs in the special access market: revenues grew at an annual rate of approximately 36 percent for both between year-end 1999 and year-end 2000,<sup>25</sup> CLEC fiber network route miles increased by about 84 percent between 1999 and 2002<sup>26</sup> and comparable expansion was experienced in the number of CLEC networks serving the largest 150 MSAs.<sup>27</sup>

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<sup>24</sup> Qwest reported ARMIS special access line count data for 1996 through 1999 included channel terminations to the POP. Data for that period reported in this, and subsequent charts dependent on line counts, has been adjusted by the company to remove channel terminations to the POP based on the percentage of channel terminations to the POP in 2000 and 2001.

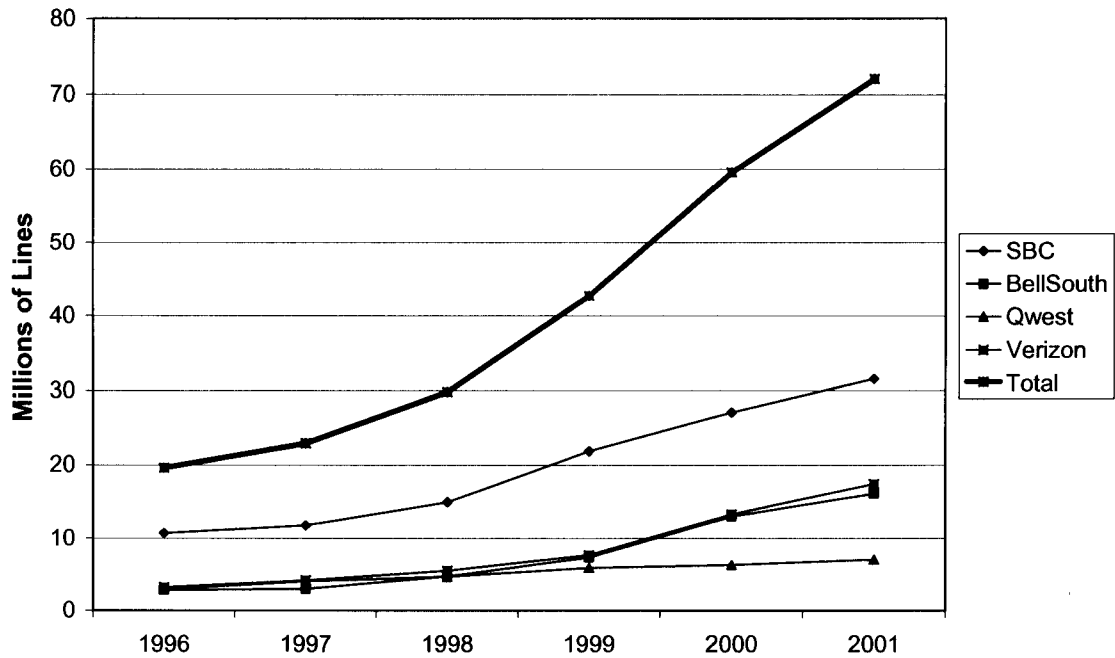
<sup>25</sup> 2002 Special Access Fact Report at 27.

<sup>26</sup> 2002 Special Access Fact Report at 12.

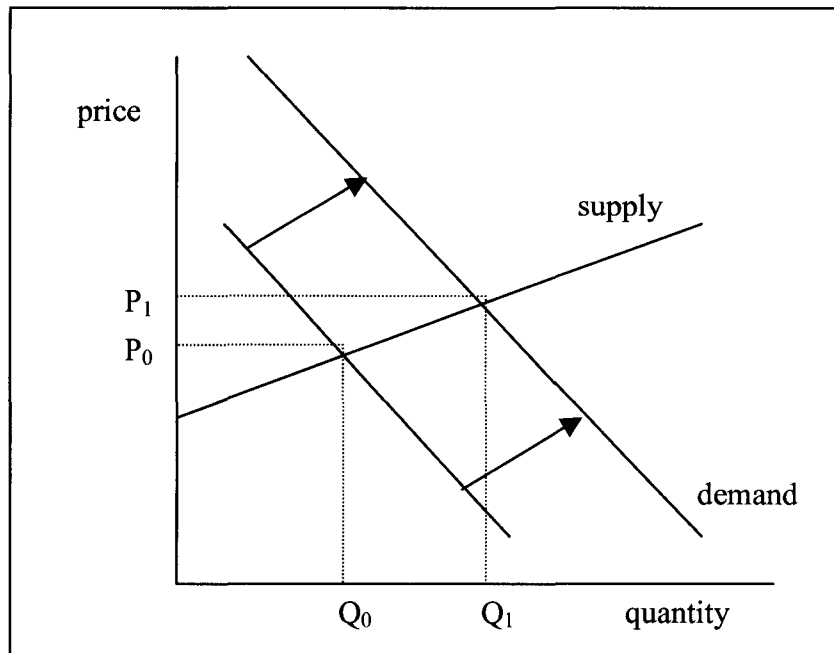
<sup>27</sup> 2002 Special Access Fact Report at 12-13.



### RBOC Special Access Line Growth



In economic theory, growth in demand unrelated to reductions in price is modeled as an outward shift in the market demand curve. In the example below, demand shifts outward and the market-clearing price as well as the volume of sales increases. The market price will increase provided the industry supply curve is not horizontal, and, at least in the short run, there is no reason to believe that the market is willing and able to supply unlimited special access circuits at current prices.



Thus, an increase in prices, revenue and demand volumes is not necessarily evidence that a large firm possesses market power, as AT&T clearly implies. Supply and demand are normally equilibrated in unregulated markets as demand expands by increases in prices and revenue until additional capacity can be brought on line, in reaction to the increased prices.

An additional source of revenue and earnings growth in interstate special access markets has been the recent growth in demand for Digital Subscriber Line (DSL)—an interstate service. DSL technology exploits unused frequencies on existing copper telephone lines to transmit high-speed data traffic — i.e., voice and high-speed data are simultaneously transmitted over the same telephone line — so that its incremental loop cost is small. As a result, increasing demand for DSL service generally increases interstate revenues with little corresponding increase in interstate regulatory costs.

The DSL revenues booked by the RBOCs to their regulated interstate accounts are large and grew rapidly during this period.<sup>28</sup> In 2001, BellSouth added more than 600,000

<sup>28</sup> SBC provides DSL service through a separate affiliate and does not book DSL revenue to its interstate special access accounts.

subscribers and booked \$264 million of DSL revenue.<sup>29</sup> Similarly, in spite of a decline in overall company earnings, third-quarter 2001 results show Qwest DSL revenue grew 80 percent, as the company logged 90 percent growth in the number of subscribers.<sup>30</sup> As the first quarter 2001 ended, Verizon had about 720,000 DSL lines — nearly five times more than it operated in the same period the preceding year.<sup>31</sup> Setting aside the question of whether the *level* of ILEC charges for their DSL services was adequately constrained by competition—primarily of cable broadband, the market share of which was twice that of the telephone companies—these dramatic increases in revenues and earnings attributable to these services can obviously not logically be attributed to any exploitation of their market power over IXCs and CLECs, as AT&T alleges. RBOC DSL revenue for Verizon, Qwest and BellSouth through September 2002 exceeded \$650 million, and, annualized, represents a 112 percent increase over total 2001 revenues of \$410 million.

Once we recognize that demand for special access services is growing rapidly, some other anomalies that AT&T points to in its Petition and the O-W Declaration can be explained. In particular, AT&T complains that special access prices—especially those subject to permissive flexibility—have increased or failed to decrease [Petition at 11-12, O-W Declaration at ¶¶28-30]. At the same time, it expresses dissatisfaction with optional pricing plans (“OPPs”) and term and volume discounts that it is either offered (as an IXC) or required to compete against (as a facilities-based self-supplier). As a matter of fact, using RBOC ARMIS 43-08 data, we find that the *growth* in special access lines fully explains the growth in revenue and that the RBOCs’ average revenue per line between 1996 and 2001 decreased by more than 1 percent per year in nominal terms and by more than 3 percent per year in constant dollars.<sup>32</sup>

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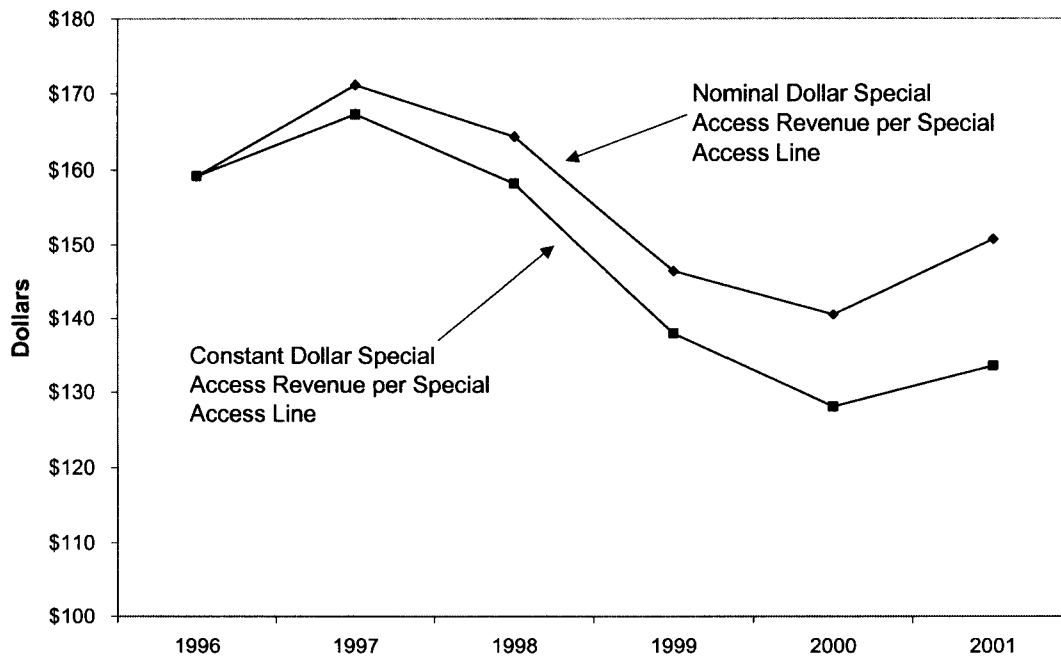
<sup>29</sup> See Revenues Rise at BellSouth, Broadband Week Direct, January 22, 2002

<sup>30</sup> CNN Money, Qwest Posts 3Q Loss, October 31, 2001.

<sup>31</sup> Richard Williamson, eWeek, Broadband Still Blooming, May 7, 2001.

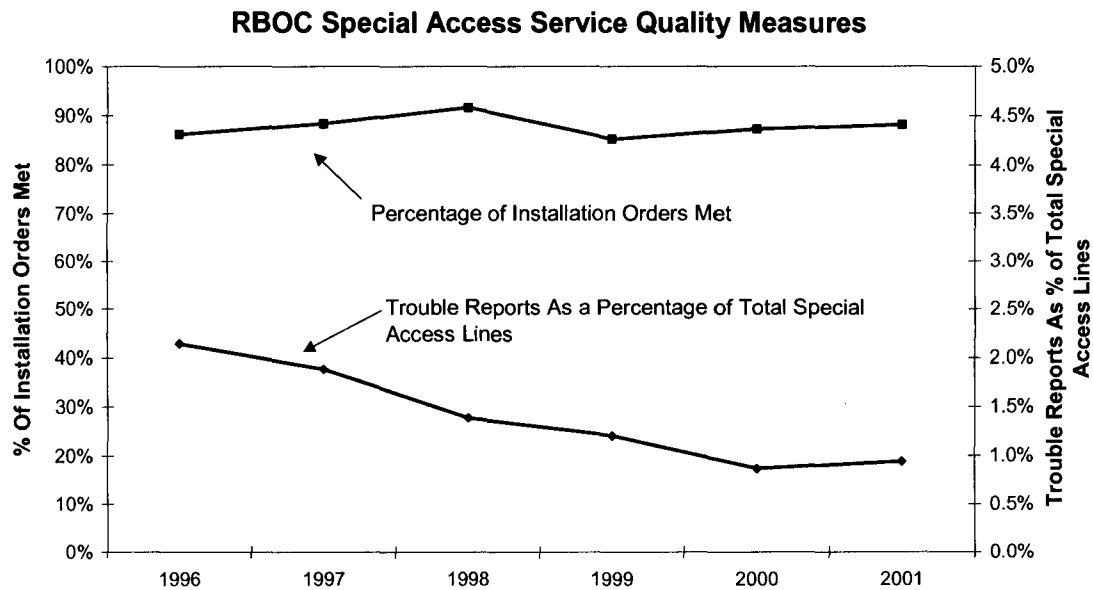
<sup>32</sup> Even these decreases are somewhat understated insofar as special access revenue includes DSL revenue but special access lines do not include DSL lines.

### RBOC Special Access Revenue per Special Access Line



Thus, the pricing flexibility exercised by some RBOCs during 2001 had no noticeable effect on their special access revenues per line, and AT&T's dire complaints of massive price increases likewise appear to be belied by the data.

Finally, AT&T infers the exercise of RBOC market power from its claim that the quality of the special access services it buys, particularly provisioning, is poor and deteriorating [Petition at 15, O-W Declaration at ¶31]. Again, the ARMIS data, measured per access line or per provisioning order, tell a very different story. On average, trouble reports per access line fell in half during the 1996-2001 period, and the percentage of installation order commitments met has remained consistently high throughout the period. Nothing in the picture remotely suggests the exercise of market power by allowing service quality to deteriorate.



In short, the basic ARMIS data show that on a per-occurrence basis, there has been an improvement, not a deterioration, in the quality of the RBOCs' special access service over this period, let alone any deterioration associated with or attributable to their having been accorded pricing flexibility in 2001 and 2002.

#### **IV. AT&T's Proffered Evidence Has Nothing to do with Pricing Flexibility.**

In its Petition and O-W Declaration, AT&T presents quantitative evidence which it claims shows that the pricing flexibility granted by the Commission has been injurious to both competitors and customers. In this section, we show that whatever the merits of these claims, they cannot be attributed to the introduction of pricing flexibility.

AT&T cites RBOC data on the level and growth of special access earnings and revenues for the period 1996-2001 as evidence that special access pricing flexibility has enabled the RBOCs to increase prices profitably.<sup>33</sup> The obvious problem with this

<sup>33</sup> The data is derived in the Declaration of Stephen Friedlander, Exhibits 1 and 2. The Petition graphs both earnings and revenue data for the years 1996 through 2001, and the O-W Declaration repeats the graph of earnings and cites the revenue results. Both the Petition and the O-W Declaration argue that the level and growth of earnings are evidence of market power [Petition at 8, O-W Declaration at 12], and the Petition infers the presence of RBOC market power from the fact that revenue increased despite price increases [Petition at 14].

inference is that special access pricing flexibility began only in 2001 and was implemented transitionally over the 2001-2002 period . According to AT&T,

[a]s of the 2002 tariff filings, approximately 59 percent of the Bells' special access revenues (excluding GTE) are no longer subject to price cap regulation [Petition at 11, no citation of source]

If AT&T is correct, a large fraction of RBOC special access service remains under price cap controls today. Moreover, where pricing flexibility has been granted at all, it has been authorized and implemented quite recently. According to the schedule shown below, the first grant of pricing flexibility was for BellSouth on December 15, 2000, followed by Verizon and SBC (on March 14, 2001). Qwest first received its authorization in April 2002. In interpreting the Table, observe that (i) the date on which pricing flexibility was actually implemented was frequently some two months after the RBOC's petition was approved by the Commission<sup>34</sup> and (ii) as the table makes clear, whatever the merits of AT&T's criticisms about the level and growth of RBOC earnings and revenues—merits that we criticized above—they have nothing to do with their authorization to price special access flexibly. RBOC accounting earnings and revenues for interstate special access services grew steadily from 1996 to 2000—*before* pricing flexibility was permitted. Again, according to AT&T, earnings for most RBOCs exceeded 11.25 percent, but that, once again, was before special access pricing flexibility was implemented. Qwest's experience, of course, has no bearing at all on the issue, since it had no such authorization during the period covered by AT&T's data.

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<sup>34</sup> For example, SBC's first petition for flexibility was approved on March 14, 2001 and implemented in tariffs filed on May 16, 2001. Its second petition was approved on April 11, 2002 and implemented on June 18, 2002.

Number of MSAs Granted Pricing Flexibility							
Authorized			SBC	VERIZON	QWEST	BELLSOUTH	TOTAL
15-Dec-00	Chan Term	Phase 1				11	11
		Phase 2				26	26
	Transport	Phase 1				1	1
		Phase 2				38	38
14-Mar-01	Chan Term	Phase 1	18	13			31
		Phase 2	4	11			15
	Transport	Phase 1	13	6			19
		Phase 2	28	40			68
22-Mar-02	Chan Term	Phase 1		15			15
		Phase 2		8			8
	Transport	Phase 1		6			6
		Phase 2		4			4
11-Apr-02	Chan Term	Phase 1	7				7
		Phase 2	8				8
	Transport	Phase 1					0
		Phase 2	10				10
24-Apr-02	Chan Term	Phase 1			11		11
		Phase 2			20		20
	Transport	Phase 1			2		2
		Phase 2			31		31
22-Nov-02	Chan Term	Phase 1				2	2
		Phase 2				4	4
	Transport	Phase 1				3	3
		Phase 2				4	4

But what about the AT&T argument that high and increasing earnings and revenues imply that RBOCs have had and retain significant market power—that IXC's have no competitive alternatives—so that granting pricing flexibility could have anticonsumer and possibly anticompetitive effects? There are three responses, in addition to the fallacy of using regulatory earnings to measure economic profit, which we will discuss in the next section. First, the levels and trends of the data offered by AT&T were clear to all industry participants in the pricing flexibility docket. Moreover, AT&T and its economists do not claim that the data show a *change* in those patterns after pricing flexibility was permitted, and, indeed, the data show no such change. Hence, AT&T offers no useful *new* information—let alone “years of data”—that the Commission could use to determine if *pricing flexibility* has had undesirable effects.

Second, the trend and level of prices, revenue and earnings for special access in the data offered by AT&T are almost entirely the effect of price cap regulation, including the recent modification approved by the Commission in its CALLS agreement, to which AT&T was a willing signatory. Effects of the reduction in the productivity factor for the special access basket in 2000 are included in the data presented by AT&T, but presumably it and the other signatories to the CALLS agreement received other considerations for that adjustment and ought not to be asking for relief from those effects in this proceeding. Finally, timing aside, the information provided about earnings and revenues has no bearing on the presence or absence of RBOC market power in the special access markets.

#### **V. There are Competitive Alternatives to RBOC Special Access Services.**

AT&T says that it continues to rely on the RBOCs' high-capacity networks for interoffice facilities and for customer-premises channel terminations because CLEC services are unavailable or too expensive and self-supply is uneconomic because of its insufficient scale economies and difficulties in obtaining rights-of-way [Petition at 26-32].

Broadly speaking, these claims suffer from one timing problem and two errors of economic logic. As to the former, AT&T makes no attempt whatever to relate this asserted experience to the introduction of pricing flexibility for special access services. Instead, it merely repeats its general contentions about its difficulties in purchasing and supplying dedicated transport and channel termination services that have been thoroughly discussed in previous dockets. As for the erroneous economics, first, AT&T resolutely continues to ignore its ability to provide its own special access facilities; witness its meaningless claim that the "lion's share of AT&T's access dollars go to the Bells" [O-W Declaration at ¶35]. As we will proceed to demonstrate, the total "access dollars" to which it refers are only its payments to other suppliers, not its total outlays for such services—a difference that produces an enormous difference in results. What matters for CLECs and IXC's is that they have economically realistic alternatives to RBOC special access facilities available to them, not that they necessarily purchase them with "access dollars" from third parties. And, second, AT&T's generic claims about economies of



scale and sunk costs are belied by the technology and by the rapid growth of non-RBOC networks that have competed successfully against the RBOCs in those markets since shortly after divestiture.

**A. AT&T ignores its ability to supply its own special access facilities.**

AT&T complains of difficulties in *purchasing* special access facilities and services from non-RBOC suppliers. Since AT&T purchased TCG, one of the largest independent suppliers of competitive access services and by so doing took its network in-house, this complaint amounts to a blatant application of the orphan defense—in which a child murders his parents and then begs the Court for mercy on grounds that he is an orphan.

During the years in which the Commission examined alternatives to the RBOCs, the participating parties regularly documented the breadth, depth, reach and growth of networks supplied by Competitive Access Providers (“CAPs”) on a wholesale basis to IXC and CLEC and on a retail basis to large corporate customers. The business plan for a typical large CAP (in this case one that has since been acquired by WorldCom) was simple enough:

The Company sells its services primarily to IXCs, ISPs, wireless carriers and business, government and institutional customers who are high volume users of telecommunications services. ... **Through the deployment of state-of-the-art fiber optic networks and switches, the Company is able to provide the IXCs served by its networks with high quality, reliable services at prices less than those the regulated ILECs currently charge.** The Company can expand its capabilities to offer these services beyond the locations served by its networks by interconnecting its facilities with the facilities of the ILECs, IXCs and other providers of telecommunications services....

...**As an early entrant** in selected second and third tier cities, the Company believes it can attain a leadership position by **securing needed franchises and rights-of-way, installing robust state-of-the-art CLEC networks and facilities and establishing customer relationships with IXCs, ISPs, wireless carriers and business, government and institutional end users that will enable it to take advantage of the attractive potential growth rates for local exchange service revenues in those markets.** The Company is also pursuing opportunities in selected first tier markets (those with populations over two million) utilizing the Company's existing operational capabilities in conjunction

with operating agreements with the Company's major IXC customers ....  
**The Company's networks are generally designed to access at least 70% to 80% of the identified business, government and institutional end user revenue base and the IXC facilities...and substantially all of the central offices of the ILECs within their markets.**<sup>35</sup>

Comparing the highlighted passages above with AT&T's litany of difficulties raises obvious questions. If Brooks Fiber could compete successfully against existing ILEC prices by installing "state-of-the-art fiber optic networks and switches" to serve IXCs, what are we to make of AT&T's sweeping assertion that economies of scale and the risk of sunk costs make special access circuits a "natural monopoly?" [O-W Declaration at ¶43]. If Brooks Fiber, as an "early entrant" into second and third tier city markets, can obtain "needed franchises and rights-of-way," how "enormous" is the RBOC first-mover advantage of which AT&T complains? [O-W Declaration at ¶¶44-45]. If Brooks Fiber can access 70 to 80 percent of its business, government and institutional revenue base and IXC POPs and all of the RBOC central offices, why is AT&T able to reach only 5 percent?

Of course, the claims of one such competitor—a competitor, moreover then acquired by the country's second-largest IXC—just as AT&T itself acquired Teleport—might logically be subject to some discount, particularly in light of the subsequent financial history of its acquirer. The fact is, however, that the CAP industry grew rapidly following this and similar business plans throughout the early 1990s. According to FCC statistics,<sup>36</sup> CAP route miles and fiber miles grew at annual rates of 59 and 67 percent respectively from 1990 through 1998. Tables 14 and 15 from the FCC's "Fiber Deployment Update for Year End 1998" show the state of the CAP industry roughly at the time the Commission was considering special access pricing flexibility and consolidation in that CAP industry took place.

While consolidation, reorganization and bankruptcies have affected much of the industry since 1990, and devastated it financially in the last year or two, they have not fundamentally affected the physical facilities. The corporate names attached to the circuits in the attached tables may have changed as the growth in fiber capacity caught up

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<sup>35</sup> Brooks Fiber 10-K Report, fiscal year ending December 1996, emphasis supplied.

<sup>36</sup> FCC, "Fiber Deployment Update for Year End 1998."

with and exceeded the growth in demand, but the capacity itself remains in place, as the basis for a great potential elasticity of competitive supply, which continues to protect customers from unjustified RBOC price increases.

Table 14: Competitive Access Fiber Systems -- 1990 to 1998 *									
Company Name	1990	1991	1992	1993	1994	1995	1996	1997	1998
	Route Miles								
Brooks Fiber	109	141	193	264	264	480	1,059	2,494	2,494
Electric Lightwave		6	104	126	225	466	516	952	1,426
e.spire (ACSI)							697	1,061	1,781
GST Telecom							305	415	849
Hyperion							2,887	4,761	5,666
ICG		105	132	151	424	637	2,073	2,872	4,208
Intermedia (ICI)	159	165	213	335	372	561	605	605	1,016
Kansas City Fib. Net	91	94	97	200	200	200			
MCImetro						2,338	2,948	2,948	NA
McLeod USA	65	75	95	121	116	NA	2,352	NA	6,436
Metromedia									380
MFS (WorldCom)	309	546	1,133	1,530	2,387	3,112	3,523	3,858	4,203
MHLightnet									148
NEXTLINK									2,477
RCN									1,700
Teleport (TCG)	468	647	1,158	2,276	4,135	5,823	7,182	9,474	11,417
Time Warner Telecom	59	86	88	96	348	3,312	4,232	5,911	6,968
Total Reported:	1,259	1,865	3,213	5,099	8,471	16,929	28,379	35,351	51,169
	Thousands of Fiber Miles								
Brooks Fiber	2.6	3.8	4.3	6.2	18.0	24.3	71.3	215.2	232.0
Electric Lightwave		0.5	6.8	11.7	20.5	NA	61.5	108.4	128.3
e.spire (ACSI)							48.8	92.5	157.2
GST Telecom							21.5	38.4	64.3
Hyperion							138.6	220.0	272.0
ICG		4.8	6.5	8.6	19.0	28.8	69.6	108.1	132.3
Intermedia (ICI)	2.9	3.0	5.2	10.2	11.3	20.5	24.1	35.0	40.4
Kansas City Fib. Net	2.5	2.6	2.9	NA	3.7	3.8			
MCImetro	NA	NA	NA	NA	NA	NA	NA	NA	NA
McLeod USA	1.6	1.8	3.7	5.0	3.0	NA	123.9	NA	382.9
Metromedia									160.0
MFS (WorldCom)	17.2	29.8	41.4	67.0	106.9	188.0	229.9	283.7	359.6
MHLightnet									4.7
NEXTLINK									195.5
RCN									86.6
Teleport (TCG)	22.2	28.4	43.7	100.5	171.7	267.1	364.8	491.1	549.7
Time Warner Telecom	0.5	1.2	1.2	1.4	10.4	107.9	151.7	233.5	272.4
Total Reported	50	76	116	211	365	640	1,306	1,826	3,038

Table 15: Competitive Access Fiber Systems -- Other Latest Available Data -- 1998 \*

Company Name	Sheath Miles	Average Fibers per Route	Investment Millions \$	Buildings Served	States Served
Brooks Fiber	2,494	93.0	NA	NA	20
Electric Lightwave	1,426	90.0	NA	2,686	7
e.spire (formerly ACSI)	1,781	88.3	NA	3,231	22
GST Telecom	917	75.7	170.6	689	8
Hyperion	NA	48.0	300.0	6,721	12
ICG	NA	31.4	#N/A	5,397	7
Intermedia (ICI)	1,016	39.7	#N/A	4,342	12
Kansas City Fiber Net	#N/A	NA	NA	276	2
MCImetro	NA	NA	NA	NA	33
McLeod USA (formerly MWR)	NA	59.5	193.9	1,028	2
Metromedia	NA	NA	NA	NA	NA
MFS (WorldCom)	4,376	85.6	NA	20,435	23
MHLightnet	148	32.0	NA	8	1
NEXTLINK	NA	NA	NA	NA	NA
RCN	NA	50.9	NA	NA	7
Teleport (TCG)	NA	48.1	NA	20,005	22
Time Warner Telecom	NA	39.1	NA	NA	10

Towards the end of the 1990s, consolidation in the telecommunications industry sharply reduced the number of these competitors, and between 1996 and 1998, the three largest consolidated CAPs were further acquired by AT&T and WorldCom, as we already observed: AT&T acquired Teleport in January, 1998, and WorldCom bought MFS in August 1996 and Brooks Fiber in October, 1997. As a result, the capacity (and growth prospects) for competitive wholesale local exchange facilities was taken off the open market and brought in-house by the two largest IXC's (and two of the largest CLECs). Consequently, there are indeed fewer *independent* CAPs available to AT&T and WorldCom today when they seek alternatives to RBOC special access circuits; but, of course, the capacity of AT&T and WorldCom to supply these facilities themselves increased by the same amount. One cannot simultaneously acquire the major wholesale providers of special access circuits and then, invoking the orphan defense, complain about a shortage of independent supplies or suppliers on the open market!

The bottom line, as AT&T pursues its strategy of moving access services in-house, is of course that the fraction of its "access dollars" that "goes to the Bells"

becomes increasingly irrelevant as a measure of the competitive alternatives to RBOC special access circuits available to it and the other IXC's and CLECs.

**B. Special access markets are competitive in theory as well as in fact.**

AT&T [Petition at 29, O-W Declaration at ¶¶39-40] describes the technology of loop and dedicated transport services as characterized by either "enormous" or "substantial" economies of scale and sunk costs.<sup>37</sup> From this observation, it concludes that special access services are a natural monopoly and (presumably) that competition is or will be insufficient to justify conferring pricing flexibility on the ILECs. To put it another way, AT&T seems to believe that the extensive competition that exists in practice is not possible in theory. Again, AT&T has made this claim before, and nothing in its Petition or Declarations suggests that experience under pricing flexibility has vindicated its claims. The best economic evidence that special access services are competitive is the long and continuing history of entry and expansion of competitors and the steady decline in RBOC market share that has occurred.

Experience, even taking into account the financial meltdown of telecommunications firms, provides in itself sufficient refutation of AT&T's claims. It is worth, however, pointing to weaknesses in its supporting argument. First, it complains [O-W Declaration at ¶35] that it and other CLECs "have been able to replicate only a small fraction of the Bells' [entire] high-capacity network." It has chosen the wrong denominator in calculating that "small fraction": special access dedicated transport and channel terminations are point-to-point, not switched services, and a ubiquitous network is not necessary to participate successfully as a competitive supplier.<sup>38</sup>

Second, the main driver of scale economies for local exchange service is customer *density*—serving dense areas permits use of larger cable, larger switches and shorter loop lengths. That source of scale economies is less important for dedicated transport or other point-to-point circuits, which do not use switches and for which individual customer

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<sup>37</sup> AT&T used the former characterization [Petition at 29], its economists the latter [O-W Declaration at ¶¶39-40].

<sup>38</sup> Of course, with interconnection, switched competition need not be ubiquitous to succeed either as many niche competitors have shown.

locations provide a high volume of usage.<sup>39</sup> Moreover, insufficient demand on particular routes or inadequate assurance of demand sufficiently enduring to justify incurring the necessary heavy sunk costs [O-W Declaration at ¶¶49-52] may possibly explain why a small CLEC might find it uneconomic to undertake such investment, but they do not explain why a CAP, a group of CLECs or a wholesale fiber supplier could not. Indeed, the experience of the CAP industry has shown a willingness to invest in fiber in such markets. Wholesale local fiber suppliers such as Metromedia Fiber Networks, American Fiber Systems, Yipes and NEON have put fiber in the ground, and even though the current glut of fiber on the market has led to acquisitions, reorganizations and bankruptcies among these firms, the capacity they have installed remains. The fact that the incremental cost of operating that capacity is extremely low means that it can be brought into service quickly in response to a market price increase.

Third, AT&T claims that marketing expense is greater for entrants than for RBOCs because CLECs must “develop a brand” and incur large promotional expenditures to attract customers. As these costs are sunk, AT&T says, they constitute a barrier to entry, so that new entry cannot be relied upon to constrain the RBOCs’ special access rates [O-W Declaration at ¶45]. While these contentions are relevant to the feasibility of retail competition, they are of drastically reduced significance in the special access market, whose services—special access channel terminations and dedicated transport—are sold mainly to IXC and large businesses. Marketing and promotional expenditures and brand identity for services provided to a small number of long distance companies are much less important than for retail sales to the public at large. Similarly, retail customers of these services are large businesses which purchase them as part of networks supplied generally by the large IXCs. Marketing and branding costs are more of a problem for the RBOCs (which are essentially the new entrants into this market segment) than for AT&T, by far the largest incumbent provider. Irrespective of who the customer is, the claim that CLECs must incur higher costs than RBOCs to establish a brand may apply to some of them but surely not to AT&T and WorldCom, which already have business relationships with nearly every customer and who have long-established

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<sup>39</sup> That is, customers whose demand volumes warrant DS-1 or higher service can be served efficiently by direct connections from an IXC point of presence without requiring intermediate aggregation.

brands and name recognition, particularly in the market segments for which special access is purchased.

## **VI. There are no Anticompetitive Effects in Adjacent Markets.**

AT&T claims that excessive special access prices impede competition in both local exchange and long distance markets [Petition Section II, O-W Declaration Section V]. The Company has made this argument regularly in the past but has proffered no evidence from the recent experience with special access pricing flexibility to support or justify its relitigation here.

### **A. Pricing flexibility fosters efficient competition in retail local exchange markets.**

AT&T's quarrel here is with the use and commingling restrictions on the availability of unbundled network elements, not with flexibility in the pricing of special access. Its claim is that because of those restrictions, CLECs cannot afford to avail themselves of the opportunity to lease the circuits they need to interconnect their own switches or transport facilities at the favorable TELRIC-based UNE rates, but must instead pay the much higher special access charges of the ILECs. Ignoring for the moment the rationale of those use and commingling restrictions, the argument is on its face peculiar from an economist's perspective. AT&T and its economists are attempting to assure the Commission that if these restrictions are lifted (or special access prices reduced), IXC and CLECs will be more rather than less inclined to invest in their own facilities rather than use those of the RBOCs.<sup>40</sup> Considering that special access facilities and services are a factor of production for CLECs and IXCs, AT&T is in effect claiming that its demand curve (and those of other CLECs and IXCs) for RBOC special access facilities and services is, perversely, upward-sloping in relation to price. A more likely explanation of AT&T's preference is that its factor demand curve is indeed downward sloping, and it recognizes the economic axiom that, all else equal, a reduction in a factor price leads to its more intensive use. The result might well be more entry, but it would

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<sup>40</sup> AT&T argues that high special access prices *indirectly* impede CLEC investment in switches (O-W Declaration at ¶49) and transmission facilities (O-W Declaration at ¶51) because RBOC facilities are necessary to link CLEC facilities into a network. But at the same time, high special access prices *directly encourage* CLEC investment in their own transmission facilities. AT&T is effectively saying that RBOC

surely be *less* facilities-based and more based on use of RBOC circuits and services. Thus, it is difficult to understand how the assertedly excessive special access prices charged AT&T by the RBOCs could constitute “a major barrier to entry by potential facilities-based competitors into retail markets for local telephony.” [O-W Declaration at ¶48]

In addition, the use and commingling restrictions serve an important economic function: namely to prevent arbitrage between two sets of regulated prices, set intentionally by application of different ratemaking principles. On the one hand, carrier access charges were established at divestiture and set intentionally above incremental cost in order to continue the flow of contribution from long distance services to local exchange services. On the other hand, TELRIC-based UNE charges were set (in principle) at incremental cost (plus a small margin) in order to encourage entry into local exchange telephony. Obviously, applications of these differing ratemaking principles can give rise to different prices for similar services, and the purpose of the use and commingling restrictions is simply to reduce the amount of arbitrage artificially generated by those differences that would undermine the Commission’s regulated carrier access charges.

Finally, it is worth observing that despite AT&T’s concern for the viability of local exchange competition, retail local competition is extremely healthy. In the teeth of a dramatic downturn in the economy and in the telecommunications sector, CLECs continue to invest and CLEC market shares continue to grow. Although UNE-P is probably the fastest-growing method of entry, in most states, substantial facilities-based entry has taken place.<sup>41</sup> While parties can disagree whether the competitive glass is half-empty or half-full, it is certainly the case that CLECs have been able to overcome the potential entry barriers listed by AT&T and compete successfully against the ILECs in the local exchange market.

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special access facilities generally behave as complements to CLEC facility investment rather than as substitutes.

<sup>41</sup> See the UNE FACT REPORT 2002, Prepared for and Submitted by BellSouth, SBC, Qwest and Verizon in CC Docket Nos. 01-338, 96-98 and 98-147.



## **B. Targeted pricing and Volume/Term contracts are procompetitive.**

After airing its claims that RBOC special access prices are too high, AT&T then contends that they are, at least in some circumstances, also too low. The O-W Declaration [¶¶53-63] asserts that Phase I and II pricing flexibility would permit the RBOCs to engage in targeted price reductions to discourage entry along particular routes and so prevent competitors from serving IXC, CLEC and end-user customers. The Petition [at 18-23] complains about downward pricing flexibility, customer foreclosure through multiperiod contracts and “severely anticompetitive” OPPs that would commit AT&T to minimum annual purchases over multiple years to obtain a discount.

It is important to point out at the outset that these allegations of strategic anticompetitive behavior are entirely theoretical. AT&T has presented no evidence to suggest it has in fact occurred, let alone as a result of the ILECs’ recent receipt of limited special access pricing flexibility. Nonetheless, in assessing these complaints, three relevant economic points must be borne in mind.

### **1. Downward pricing flexibility is in itself procompetitive.**

In general, regulators should always look upon proposals to restrict price reductions with a jaundiced eye. Price reductions are painful to competitors, but they are the essence of the competitive process. Restricting the incumbent’s ability to lower prices denies consumers the benefit of those reductions immediately and reduces future consumer welfare by weakening competition and allowing inefficient competitors to remain in the market. As three well-known economic advisors to pre-divestiture AT&T observed,

These dangers remain even when regulatory commissions purport to prevent only discriminatory price competition. When an industry is subject to decreasing costs, the only way a supplier can cover his total costs while at the same time taking fullest possible advantage of scale economies is in fact to engage in price discrimination—specifically, to reduce prices selectively down toward incremental costs in markets where demand is relatively elastic. By prohibiting such suppliers from engaging

in selective price reductions in order to protect smaller rivals from the resultant competition, regulatory cartelization fosters inefficiency.<sup>42</sup>

The offer of special deals to attract or retain customers, whether justified by differences in cost or actually discriminatory in the technical sense, is an essential way in which price competition takes place in the real world. That they may discommode or injure competitors is an inherent consequence; but one of the most fundamental distinctions in economics generally, and antitrust law specifically, is between the inflicting of harm on competitors, with a resulting net increase in consumer welfare, from weakening or impairment of the competitive process, resulting in an ultimate or net decrease in consumer welfare. The distinction is of course extremely difficult to make in practice, but it is absolutely fundamental. The fact that one of us has consistently over the decades emphasized the danger that such selected, discriminatory reductions can be predatory in intent or effect must not be permitted to obscure his consistent recognition of that crucial distinction, in principle. Any general restrictions on the ability of RBOCs to respond to Requests for Proposals or offer optional discount packages would restrict active competitive behavior and harm consumers by denying them both the direct economic benefit of any such offerings and of responses by competitors that they tend to compel, reducing the vigor of competition in the market. Term and volume discounts expand consumer choice and ultimately expand demand, increasing consumer welfare directly. Reasonable termination penalties are an inherent part of the bargain and make such plans possible by reducing opportunities for cheating; without such penalties, the plans could not be offered and the increase in consumer welfare, both direct and indirect, would be lost. Finally, distinguishing among differently-situated customers with optional discount packages can expand sales and increase consumer welfare, so that removing the option of downward pricing flexibility would be anticompetitive. And in all of the above cases, the fact that only the RBOCs would be precluded from using them would distort the process of competition and sacrifice its benefits to special access customers.

None of the foregoing arguments conflicts in any way, in principle, with the repeated emphasis by one of us on the dangers of predation—in particular, typically

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<sup>42</sup> W.J. Baumol, O. Eckstein and A.E. Kahn, "Competition and Monopoly in Telecommunications Services," November 23, 1970, AT&T Reprint.

manifested in the offer of deep price reductions highly selectively, to combat a typically much smaller competitor, followed by the quick restoration of previously prevailing prices once the competitive threat has been eliminated. But never have his warnings been unaccompanied by an explicit recognition that it would be injurious to competition and the welfare of consumers generally to prohibit the mere offering of special deals and discounts, and by a reminder that such blanket prohibitions would in practice entail a prohibition of competition itself.

The Commission effectuated its concern that selective price reductions might be used to thwart competition in its Pricing Flexibility Order by requiring the presence of competitors using their facilities before pricing flexibility by incumbents would be permitted. AT&T [Petition at 18-21] claims “[e]xperience now shows” that the Commission was mistaken: the only “experience” it cites, however, is the RBOCs’ offerings of OPPs.<sup>43</sup> In fact, CAPs and CLECs have already invested heavily in facilities in major markets; those facilities are not going to go away and can be employed competitively at very low incremental costs. Any anticompetitive strategies aimed at frustrating new entry would be too late to be effective. Moreover, the customers for RBOC special access services are largely CLECs and IXC, and the largest of them, AT&T and WorldCom, are also the largest owners of CAPs. While AT&T expresses concern that selective price reductions by the RBOCs might make competition difficult for independent suppliers of special access facilities and services, even selective price reductions would have no anticompetitive effect on the decisions of AT&T and WorldCom to supply their own needs, at low incremental cost. Finally, as AT&T has argued on its own behalf for decades—from the time of Telpak to its more recent Tariff 12 offerings—customers are better off when incumbents, in addition to other suppliers, are able to respond to contract proposals from large business customers.

## **2. OPPs with term and volume commitments fill an important market need.**

Any carrier precluded from offering optional pricing plans with term and volume discounts would be placed at a significant competitive disadvantage in the special access

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<sup>43</sup> AT&T makes the oxymoronic assertion that the RBOCs use market power to *force* carriers to use their *optional* pricing plans (Petition at 21).

market. Long-term contracts are used to minimize risk exposure and stabilize production requirements and costs over time. In addition, when the buyer or seller incurs heavy sunk costs as part of the transaction, both parties are better off under effective long-term contracts. Common examples of such costs in special access markets include network design of customer-specific facilities and the purchase of transaction-specific equipment and facilities. Under such contracts, the buyer and seller are both assured that (i) their sunk costs will eventually be recovered from the transaction for which the costs were incurred and (ii) up-front sunk costs can be amortized and recovered over the life of the transaction, better aligning costs with revenues. Long-term contracts thus have salutary effects in the form of risk and cost reduction for both suppliers and customers.

AT&T complains [Petition at 22-23, O-W Declaration at ¶¶61-62] that the RBOCs have forced it into signing long-term contracts and OPPs that oblige it to “commit to certain levels of annual purchases to obtain the discounts.” It also complains that those contracts come with “sizable penalties for early termination” and that the RBOCs have “insisted on specific penalties for migrating traffic to competitors.” These complaints are without merit. First, the plans are optional, not just nominally but in reality: AT&T is not in fact obliged to choose them. As always, and as it does on a large scale, it can supply its own special access services, purchase them from other competitive suppliers or continue to buy them from the RBOCs at the ordinary tariffed rate.

Second, AT&T admits [Petition at 22, O-W Declaration at ¶62] that the savings it realizes by taking special access service under long-term contract from the RBOCs “dwarf whatever savings AT&T could achieve by using competitive alternatives”: obviously this can mean only that the OPP offers it additional benefits that outweigh the additional restrictions. Having the choice, irrespective of which choice it actually makes, clearly makes AT&T better off. Third, AT&T wants to have its cake and eat it: it values the savings from RBOC OPPs but complains about the penalties that apply for early termination. Such penalties are a standard practice in the offering of long-term contracts because without them, the discounts could not be offered. Obviously, if a customer could sign a long-term contract, obtain a discounted price on the seller’s expectation that it will be fulfilled and then breach it without penalty when a better offer came along, such

contracts, with the benefits they offer both parties, would be simply infeasible in the first place and end user customers would, ultimately, be the losers.

### **3. RBOC OPPs cannot “lock up” the largest special access customers.**

Term commitments in multi-year contracts do not “lock up” customers in an anticompetitive manner, any more than General Motors locks up a customer when it sells or leases a Buick that the customer will drive for the next five years. Every special access carrier offers its customers multi-year contracts with early termination penalties, and while each customer that signs such a contract is in principle removed from the market for the services for which it has contracted, every carrier has a fair shot at securing the customer in the first place. The total demand for data services is growing at double-digit annual rates, and new customers and demands come into the market continuously. There is no reason why competition for multi-year contracts for large customers must be any less vigorous—any less beneficial for customers—than competition confined to month-to-month service arrangements.

Moreover, while AT&T claims that the RBOCs “have locked up the largest special access customers” [Petition at 23], those customers are, of course, the largest IXC and CLECs—AT&T and WorldCom. As both of them possess extensive local exchange networks from their absorptions of Teleport, MFS and Brooks Fiber, it is difficult to understand how their having the option of entering into term contracts with an RBOC could lock them up involuntarily or subject them to monopolistic exploitation.

### **C. Long Distance Markets**

As in many other dockets since 1984, AT&T [Petition at 23-24, O-W Declaration at ¶¶64-69] asserts that setting access charges above incremental cost has anticompetitive effects in the long distance market, where RBOCs both supply carrier access services and compete for retail customers. The RBOCs, AT&T alleges, can use their “market power in the provision of special access” to sell that service to IXCs at prices above cost, while incurring only the underlying costs themselves in their own use of special access to offer competing long distance services. Such a strategy, AT&T claims, raises rivals’ (i.e., IXCs’) costs, and, in the limit, subjects them to anticompetitive price squeezes. It cites

two post-1999 examples as purported evidence that this theory has some relevance to the current proceeding, but in fact neither example demonstrates anything about the effect of special access *pricing flexibility* on long distance competition.

The flaws in AT&T's reasoning are well-recognized. First, pricing special access services above cost can not impair competition in the long distance market because the RBOC long distance affiliates buy special access under the same tariffs and OPPs as AT&T.<sup>44</sup> Therefore, pricing special access above cost can not generate a differential advantage for the RBOC's own long distance service or impose an anticompetitive price squeeze on an IXC.

But, AT&T complains, the cost that the RBOC actually incurs in providing access to itself (or its affiliate) is less than the cost its rivals incur when they buy access from it. How could such access prices not be anticompetitive, it asks?

The answer is simple. True, when AT&T wins the retail customer, it may purchase special access from an RBOC, in which event the cost it incurs is the price the RBOC charges, whereas when the RBOC wins the retail customer, it incurs only the incremental cost of providing the equivalent of special access. In the latter case, however, the RBOC also gives up the contribution (price less incremental cost) from special access that it would have received if AT&T had served that retail customer. Special access charge revenue (when AT&T supplies the retail service) is revenue that the RBOC foregoes when it supplies the retail customer itself. The higher that access revenue, the higher the retail price the RBOC long distance affiliate would have to charge to make long distance service profitable for the RBOC as a whole, as well as to make long distance service profitable on the books of its long distance affiliate. Thus AT&T is simply wrong [O-W Declaration at ¶68] when it claims that the RBOC can charge long distance prices "that do not reflect all of the artificially elevated access prices," and "divert substantial business from the IXCs to itself." The RBOC affiliate's retail price reflects to the penny what IXCs pay for access, as is required by both the law and by economic self-interest.

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<sup>44</sup> In particular, Section 272(e)(3) of the Act requires BOCs to purchase carrier access out of the same tariffs as their competitors and to impute those carrier access charges into their long distance prices, so that all competitors effectively pay the same price for the same carrier access services.

Finally, AT&T is wrong again [O-W Declaration at ¶66] in supposing the RBOC can impose a price squeeze, earning a higher margin on its sale of access services to IXC competitors than its affiliate earns on its retail service. First, such pricing cannot occur unless the RBOC affiliate prices its long-distance service below its incremental cost, since the affiliate buys access out of the same tariff as the IXCs. Such predatory pricing is possible, of course, but is an unlikely strategy because it entails the affiliate sacrificing profits for some period of time with no reasonable hope of being able to drive its IXC competitors out of the market, and then raise toll prices without attracting entry and recoup lost profits, greatly facilitated by the ability of entrants to use facilities already in place, at very low incremental costs. Second, if one ignores the affiliate's balance of costs and revenues and looks only at the RBOC's, the same analysis holds. When the RBOC receives from the IXC a greater margin above cost for a minute of access than it receives from selling a minute of retail toll service, it loses money on every minute of those retail sales. For example, assume toll competitors must buy the RBOC's switched access service for 5 cents per minute and the RBOC's incremental cost of supplying access is 1 cent per minute—yielding it a margin or contribution of 4 cents. Suppose, in addition, that the RBOC affiliate's incremental cost for supplying toll is 2 cents per minute. If the RBOC's affiliate prices toll below 6 cents per minute, it would be more profitable to sell access to AT&T than to sell toll at retail.<sup>45</sup>

Hence, AT&T's conclusion that "[t]his strategy may be profitable to the RBOCs" is certainly incorrect in the short run, and only possible in the long run under circumstances in which predatory pricing in the toll market is likely to be a profitable strategy and that, we have pointed out is highly unlikely in a situation of excess capacity.

AT&T offers two examples of recent (post-1999) anticompetitive effects of access charges in long distance markets. The first is an example that apparently pertains to SBC intrastate switched access charges and toll prices in Texas. The relevance of that example to interstate special access pricing flexibility is somewhat murky, and from the details given, one cannot conclude that SBC's affiliate is pricing its toll service below the sum of its toll incremental cost and the contribution (price less incremental cost) from

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<sup>45</sup> A minute of access generates 4 cents of contribution in this hypothetical example. A minute of toll service sold for 5 cents per minute generates 3 cents of contribution.

switched access. The second example has nothing to do with a price squeeze: it merely observes that BellSouth has offered an optional package that combines Fast Packet Access Service and Frame Relay Service at an attractive price. While AT&T complains that it cannot get discounted Fast Packet Access Service without buying Frame Relay Service, it does not explain why that option is anticompetitive. As long as the package is priced so that BellSouth covers its incremental costs as well as the contribution from any access service an IXC must buy from it, the offering is procompetitive, as well as optional. AT&T's complaint amounts to a demand to buy the second item only in a "buy one, get one free" promotion.

## **VII. Conclusion.**

Competitive activity in the special access market continues and continues to grow. RBOC average revenues per line continue to fall; service quality remains high and increases. AT&T's complaints of high RBOC rates of return are based on fully distributed costs and have no bearing whatever on its claims that the RBOCs retain market power. Similarly, AT&T's claims of high or increasing RBOC price-cost margins, especially calculated on the basis of TELRIC, are not evidence of the presence of market power when fixed costs are an important characteristic of the technology. AT&T's own price-cost margins three years after the Commission granted it pricing flexibility equal or exceed the margins of which AT&T complains here.

AT&T's submission offers neither factual nor theoretical ground on which to reverse the Commission's long standing policy of adapting regulation to the degree and character of competition in the market.

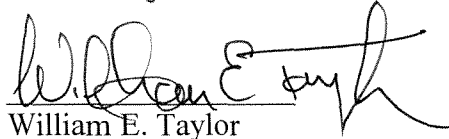


We declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on Nov. 27, 2002

A handwritten signature in cursive script, appearing to read 'Alfred E. Kahn', written over a horizontal line.

Alfred E. Kahn

A handwritten signature in cursive script, appearing to read 'William E. Taylor', written over a horizontal line.

William E. Taylor

# **Comments of BellSouth**

**RM No. 10593**

**December 2, 2002**

**Exhibit 2**

# **Special Access Competition**

**Prepared for BellSouth**

January 22, 2002

## **Special Access Competition**

This paper investigates two aspects of the current Special Access market:

1. The historic growth of competition in the Special Access market over the past 15 years
2. The current availability of competitive alternatives to BellSouth's Special Access services in that company's territory

We conclude in the first instance that nationwide, the number of competitors offering Special Access has grown steadily and often dramatically during the period.

In the second case, we conclude that in the vast majority of cases, both wholesale and retail buyers of Special Access services in BellSouth's territory are highly likely to have multiple choices of competitive alternatives to that company's Special Access services, to the point where the marketplace is able to provide any level of service performance for which there is sufficient demand.

### **History of the Growth of Competition in Special Access**

Beginning in the mid-1980s, demand for high-capacity access services based on fiber technologies created a new sector within the telecommunications industry. Starting with the largest business users and working their way down to small businesses today, competitive providers grew from a few firms to well over 500 by 2000. In addition, as IXC's grew during the period, they began establishing their own access facilities to connect to their customers directly. Today, these form another source of both wholesale and retail alternatives to ILEC Special Access.

Teleport Communications Group (TCG), formed in 1984, was the first Competitive Access Provider (CAP). TCG initially deployed a significant amount of fiber in Manhattan, both for access to satellite earth terminals outside the city and for digital services within New York City. Key targets of CAPs were large downtown office buildings in cities where the deployment cost and regulatory constraints of new fiber systems were not excessive. Other CAPs entered the market beginning in 1986 with Institutional Communications Company (ICC) formed in 1986. According to FCC

documents covering this period, there were a total of 24 such facilities-based CAPs deploying backbone fiber systems at the end of 1991<sup>1,2</sup>.

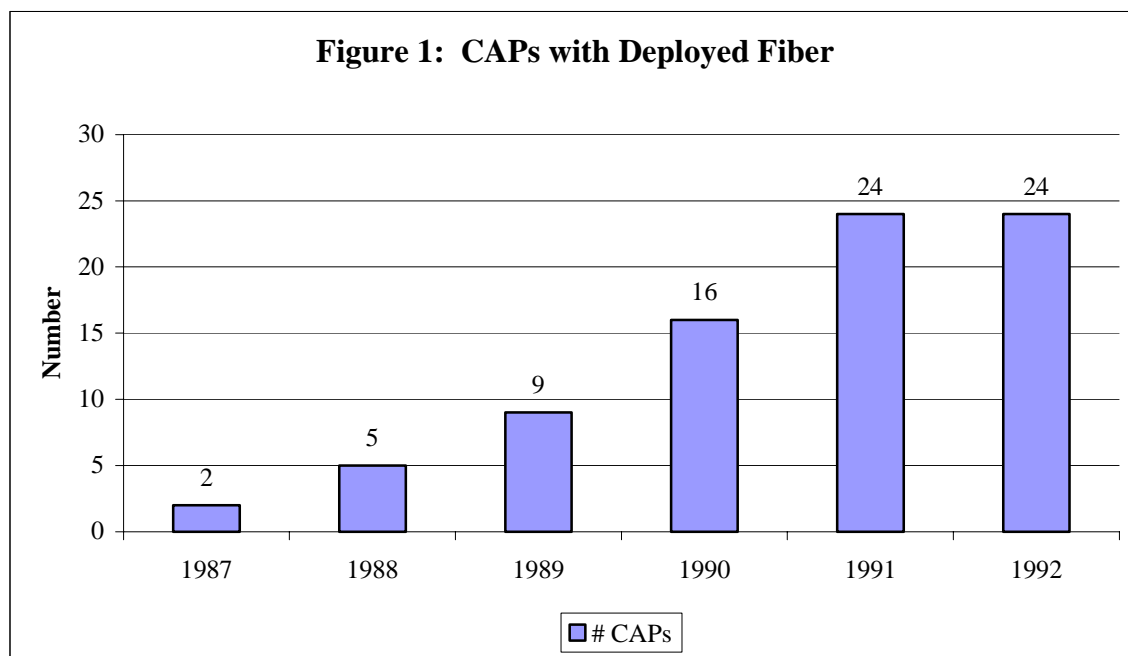
CAPs with Deployed Fiber					
CAP Name	1987	1988	1989	1990	1991
Bay Area Teleport					
City Signal					
DFW/MetroLink, Inc.					
Diginet					
Digital Direct					
Eastern Telelogic					
Electric Lightwave					
Fibernet Inc.					
ICC					
Indiana Digital Access, Inc.					
Intermedia Communications					
IOR Telecom					
Jones Lightwave					
Kansas City Fiber Net					
Metrex Corporation					
Metro Com					
Metropolitan Fiber System					
New England Digital Distrib.					
Ohio Linx					
Penn Access Corp.					
Phoenix Fiberlink					
Public Service of Oklahoma					
TCG (from 1984)					
Teleport Denver					
CUMULATIVE TOTAL	2	5	9	16	24
Total Route Miles	133	201	793	1326	2098

The level and year-over-year (YoY) growth in facilities-based CAPs is depicted in Figure 1, below. In 1992 the Commission declared that CAPs “now offer access services to large business customers in central business districts of major cities” and that many customers “do not use LEC facilities at all to connect their customer location directly with their long-distance carrier.”<sup>3</sup>

<sup>1</sup> FCC, Fiber Deployment End of Year 1990, Table 12 – Urban Fiber Systems, March 27, 1991. See also Fiber Deployment End of Year 1992, Table 14 – Urban Fiber Systems, March, 1993.

<sup>2</sup> Kessler Marketing Intelligence, *Alternative Local Carriers with Fiberoptic Metropolitan Area Networks* at 24 (Aug. 1989).

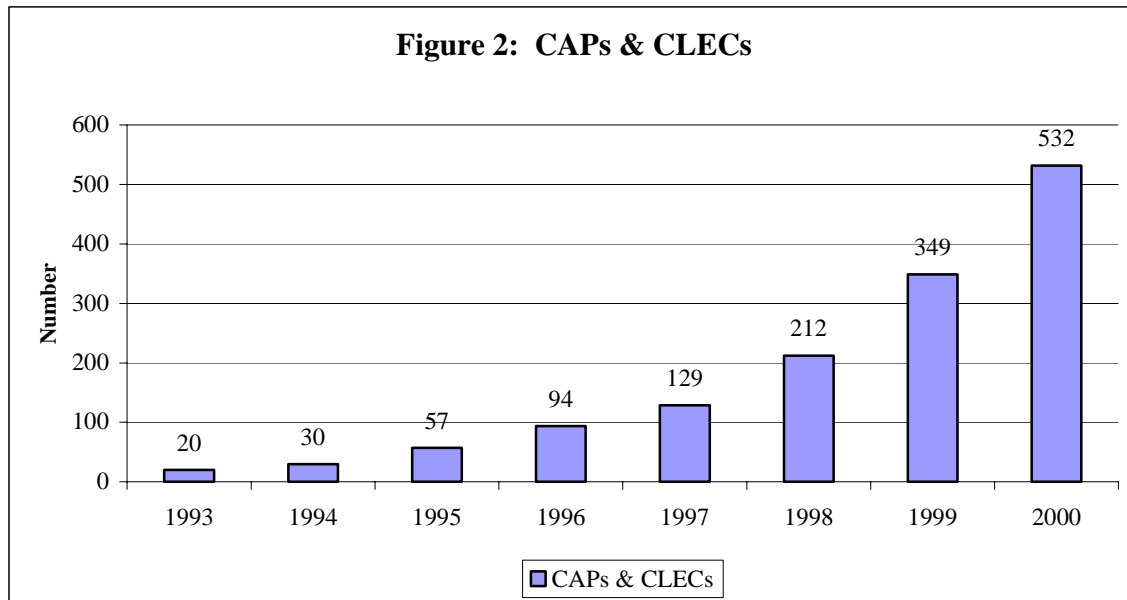
<sup>3</sup> *Expanded Interconnection with Local Telephone Company Facilities*, Notice of Proposed Rulemaking and Notice of Inquiry, 6 FCC Rcd 3259, 3260 (1991); Remarks by Richard M. Firestone, Chief, Common Carrier Bureau, FCC, Ninth Annual FCBA/PLI Conference, “Telecommunications Policy and Regulation,” FCC, Dec. 2, 1991.



Growth in the CAP/CLEC sector over the last decade has continued unabated. In its news release on the state of local competition at the end of 2000, the Commission noted “CLEC market share grew 93% over the one-year period of January to December 2000.”<sup>4</sup> In fact, according to another set of FCC documents, CAP and CLEC numbers have grown from 20 in 1993 to 532 at the end of 2000, approximately a 60% compound annual growth rate over the 7-year period.<sup>5</sup> The significant growth trend is depicted below in Figure 2.

<sup>4</sup> FCC releases latest data on local competition, May 21, 2000.

<sup>5</sup> Data filed on FCC Forms 431, 457, and 499-A worksheets. See Trends In Telephone Service, Table 9.6, August 2001 for data through 1999 and The Telecommunications Provider Locator, Table 1, November 2001 for 2000 data. These data are filed by virtually every telecommunications provider *legal entity*. Therefore they cannot be merged with the facility-based CAP listing which is tabulated by holding company.



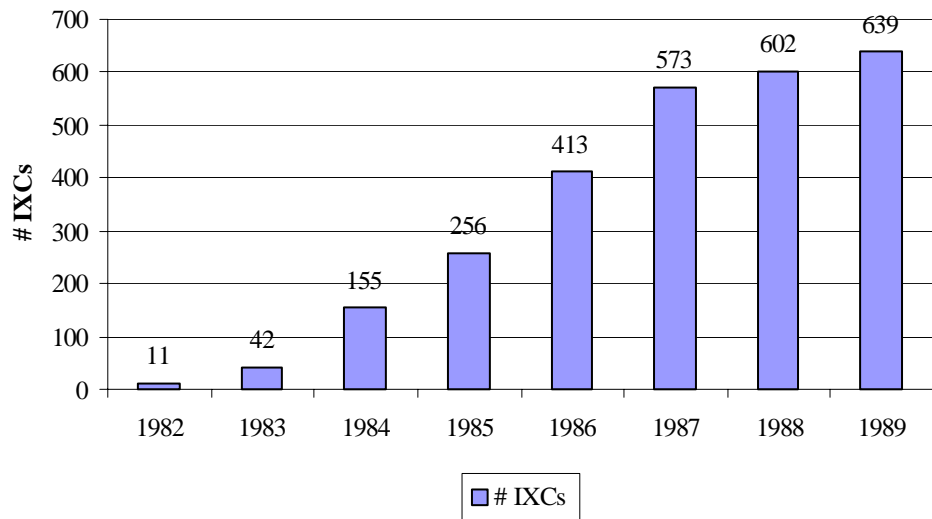
IXCs are major customers and providers of special access through their subsidiaries. We rely on Carrier Identification Codes (CICs) for the 1980s, which in the Commission's words "provides the best information available on the entry of new firms into the long distance market prior to 1986."<sup>6</sup> Beginning in 1986, a number of corporations, government agencies and other organizations began to acquire CICs for their own use, rather than for the purpose of providing telecommunications services to others. After that time, the use of such codes to estimate the number of long distance carriers became less reliable. (Because of these changes, the data from the earlier period, 1987 to 1992, cannot be merged with post-1993 data.) From 1993 onwards we rely on data filed on FCC Forms 431, 457, and 499-A worksheets.<sup>7</sup> Figures 3-4 show both views of IXC growth. The compound annual growth rate is almost 16% over the most recent 7-year period.

Over the period, well over 500 CAPS/CLECs came into existence, along with well over 200 IXCs. Although the structure and ownership of the competitive-access assets built by these firms continues to fluctuate, the steady growth in the number of competitive access providers of all types over the period indicates that there is a significant pool of facilities available to provide alternatives to ILEC Special Access.

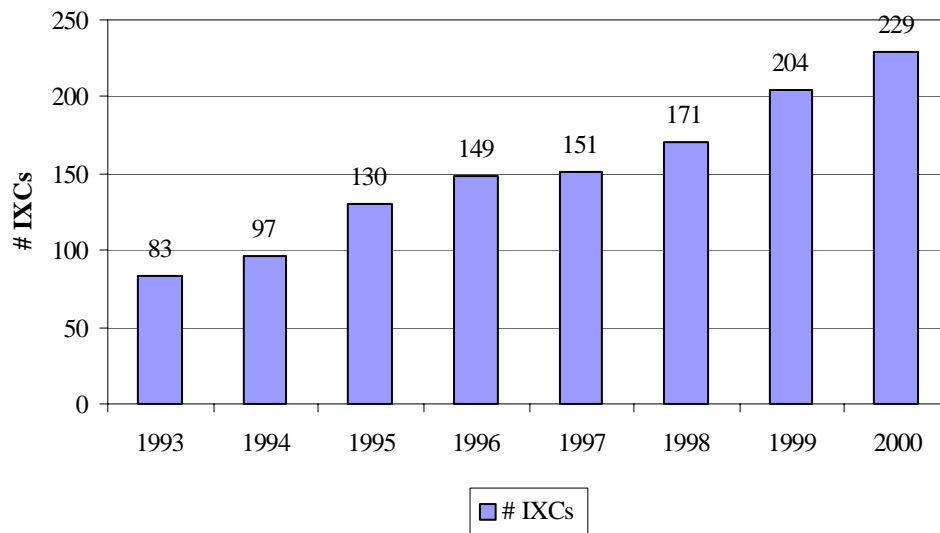
<sup>6</sup> FCC, Trends in Telephone Service, p. 10-2, August 2001.

<sup>7</sup> See Table 10.4 (Number of Toll Carriers) in Trends in Telephone Service, August 2001 and The Telecommunications Provider Locator, Table 1, November 2001 for 2000 data.

**Figure 3: IXCs Based on CIC Counts**



**Figure 4: # IXCs Reporting to FCC**





## ILEC Special Access Is Not Required by IXC and CLECs

In this section, we derive the likelihood that Special-Access type facilities will be available in BellSouth's territory. Since all carriers want to maximize the usage of their facilities, the likelihood of the presence of such facilities in a wire center indicates the availability of alternatives to BellSouth Special Access.

When an IXC or CLEC is collocated with other CLECs in an ILEC wire center, the opportunity exists for special access wholesaling among these entities as an alternative to the purchasing of ILEC special access. A conservative view of the likelihood (or probability) of finding a non-ILEC special access source within BellSouth's territory is 0.759.

<b>Table 1: Probability of an IXC or CLEC Finding a CLEC Special Access Alternative within BellSouth Territory</b>			
	IXC	CLEC	Pooled View
Likelihood	0.626	0.925 <sup>8</sup>	0.759 <sup>9</sup>

Additionally, there is an opportunity afforded to commercial enterprises to purchase retail special access from non-ILEC sources. We conservatively estimate the likelihood of CLEC retail special access availability to be 0.673. This estimate is conservative on the following grounds:

1. The estimate assumes that IXCs do not sell special access to businesses, when in fact they do.
2. Given that a business is in a CLEC serving area, the likelihood that the CLEC will offer special access is estimated state-by-state using an average (over CLECs within the state) of their percentage of on-net buildings to total connected buildings. Across BellSouth's territory we estimate this ratio at 30.9%, whereas the Commission reports that the December 30, 2000 ratio of CLEC owned lines to total CLEC lines at a higher number -- 35.1%.<sup>10</sup>
3. The analysis excludes consideration of CLECs acting as UNE connectors for other non-collocated CLECs.<sup>11</sup>

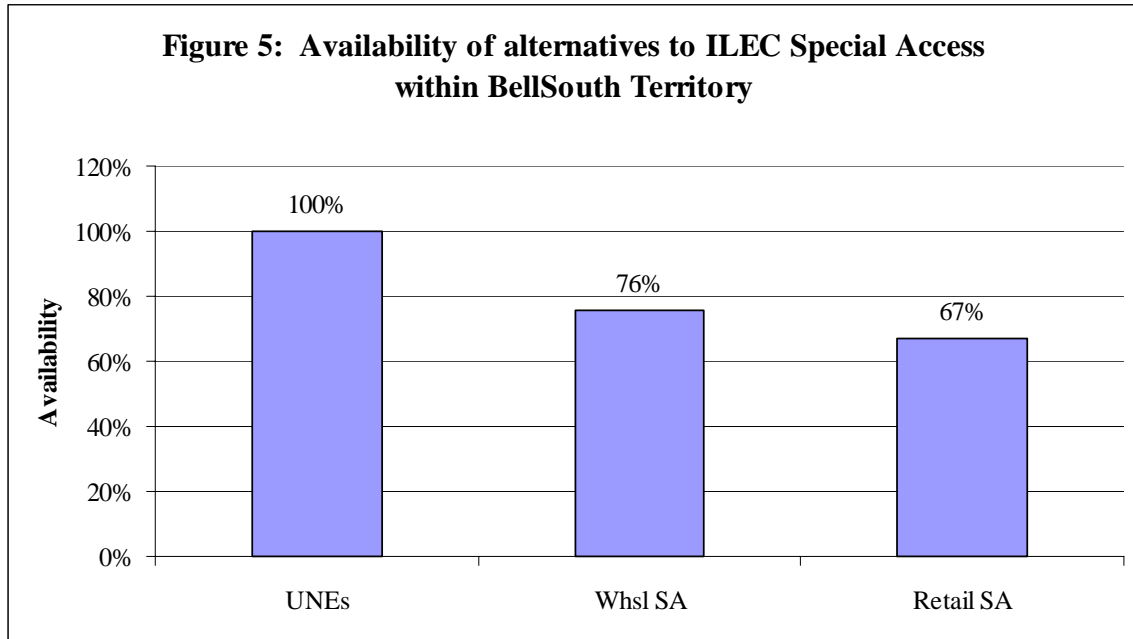
<sup>8</sup> If there are 8 CLECs, on average, collocated in BellSouth wire centers with collocation, the probability that any one chosen at random will be served by at least one of the other 7 is  $1 - (1-0.309)^7 = 0.925$ , where  $1-0.309$  is the probability of not being served.

<sup>9</sup> Of the IXC and CLEC population operating within BellSouth's territory, IXCs make up approximately 55%. See FCC Form 499-A interactive website <http://gulfoss2.fcc.gov/cib/form499/499results.cfm>.

<sup>10</sup> FCC, Local Telephone Competition: Status as of December 31, 2000, Table 3, May, 2001.

<sup>11</sup> See New Paradigm Resources Group, Inc., CLEC Report 2001, 14<sup>th</sup> Edition, p.76, 2001.

Our overall view of the availability of ILEC special access alternatives, inclusive of ubiquitous availability of UNEs for local service appears in Figure 5, below. (The derivation of these availabilities is detailed in the section following the figure.)



#### Estimation Methodology

##### 1. Estimation of CLEC Wholesale Special Access to IXCs

The foundation for this assessment rests on Table 6 of the Special Access Fact Report<sup>12</sup> rewritten here as

Table 2: IXC POPs in BST Wire Centers with CLEC Collocation				
	Number of CLECs			
	0	1	2	≥3
Probability	0.22	0.12	0.13	0.53

<sup>12</sup> Huber, P. W. and Leo, E. T., Special Access Fact Report, Submitted by the United States Telecom Association in CC Docket No. 96-98, January 19, 2000.

Additionally, in BellSouth wire centers with collocation, there are approximately 8 collocated CLECs.<sup>13</sup> This, in conjunction with Table 2, allows us to estimate the number of CLECs in the “ $\geq 3$ ” cell to be 11, which in turn lets us calculate the probability that an IXC needing Special Access alternatives will be able to find them.<sup>14</sup>

The probability of an IXC being able to purchase special access from a collocated CLEC is simply  $(1 - \text{probability that no collocated CLEC is willing to participate in the sale})$ . The likelihood that a CLEC is willing to participate in a special access sale is estimated by the fraction of its connected buildings that are on-net as opposed to being on-switch or total service resale. (We assume normal business behavior, that is, that the CLECs will want to maximize the use of their network facilities.) We estimate this likelihood to be 30.9% across BellSouth’s territory.<sup>15</sup> Therefore if there are 2 collocated CLECs, the probability of the special access sale is  $1 - (1-0.309)^2 = 0.52$ .<sup>16</sup> The final result appears in Table 3, below, with the BellSouth average being the weighted average over the four cells in Table 3 using the probabilities in Table 2.

<b>Table 3: Probability of CLEC availability for wholesale SA to IXC</b>					
	<b>Number of CLECs</b>				
	<b>0</b>	<b>1</b>	<b>2</b>	<b>&gt;3 (11)</b>	<b>BST Avg</b>
<b>Probability</b>	<b>0</b>	<b>0.309</b>	<b>0.522</b>	<b>0.983</b>	<b>0.626</b>

## 2. Estimating the Likelihood of CLEC Special Access Sales To Other CLECs and to Business Enterprises

The primary data at the BellSouth regional level for estimating the availability of CLEC wholesale special access to other CLECs and the availability of retail CLEC special access to business enterprises appears in Table 4.

<sup>13</sup> From data provided by BellSouth, the average number of collocated CLECs is derived by dividing the number of collocation arrangements by the number of wire centers with collocation within the BellSouth region.

<sup>14</sup> BellSouth average number of Collo Arrangements in Wire Centers with Collos  $\geq 3 =$

$$\frac{\sum_{i=3}^n ip_i}{1 - p_0 - p_1 - p_2} = \frac{\bar{x}(1 - p_0) - p_1 - 2p_2}{1 - p_0 - p_1 - p_2}, \text{ where } \bar{x} = 8 \text{ and } p_i = \text{probability of } i \text{ collos.}$$

<sup>15</sup> NPRG’s CLEC Reports 14<sup>th</sup> & 15<sup>th</sup> editions were the first sources for on-net and off-net buildings. When not available, the percent of on-net lines provided in Banc Of America Securities, Competitive Local Exchange Carriers Industry Outlook, p.10, February 2001, was used. Bear Stearns, CLEC Sector Initial Coverage, p.109, October 2001, was used for McLeod USA.

<sup>16</sup> The general formula is  $1 - (1-0.309)^n$ , where n = the number of collocated CLECs.

<b>Table 4: BellSouth Regional Statistics</b>			
<b>Avg/CLECs per WC with collos<sup>17</sup></b>	<b>Fraction of On-Net Bldgs</b>	<b>CLEC Share State Lines<sup>18</sup></b>	<b>% ILEC Biz Lines in WC w/ Collos<sup>19</sup></b>
<b>8</b>	<b>30.9%</b>	<b>7.8%</b>	<b>68.5%</b>

Following the train of thought outlined above, the availability of CLEC special access to collocated CLECs, on average across BellSouth's territory is  $1 - (1-0.309)^7 = 0.925$ , as shown in Table 1, above. Furthermore, the availability of CLEC special access to business enterprises is

$$(1 - 0.078) \times (0.685 \times 0.948) + 0.078 \times 0.948 = 0.673.$$

This states that businesses can only buy special access from CLECs willing to sell it and are collocated in the same wire centers as the business customers. The first term tells us that ILECs have as customers 92.2% of residence and small business lines. The second term tells us that within the ILEC market, 68.5% of its business lines are in wire centers with collocated CLECs; and these CLECs are 94.8% ( $= 1 - (1-0.309)^8$ ) likely to sell special access to those business customers. Finally, the third term tells us that within the CLEC market (7.8% of residence and small business lines), again the likelihood of selling retail special access is 94.8%.

In summary, it is highly likely that IXC, CLECs and enterprise customers looking for alternatives to BellSouth Special Access will find them.

<sup>17</sup> See note 13 above.

<sup>18</sup> FCC, Local Telephone Competition: Status as of December 31, 2000, Table 6, May, 2001.

<sup>19</sup> FCC, Trends in Telephone Service, Table 9.6, p. 9-20, March 2000.

**CERTIFICATE OF SERVICE**

I do hereby certify that I have this 2<sup>nd</sup> day of December 2002 served the following parties to this action with a copy of the foregoing **COMMENTS OF BELLSOUTH** by electronic filing and/or by placing a copy of the same in the United States Mail, addressed to the parties listed below.

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+ **VIA ELECTRONIC FILING**

Comments of BellSouth  
RM No. 10593  
December 2, 2002